



Foreign currency

Handbook

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Preface

The purpose of KPMG Handbooks is to assist you in understanding the application of US GAAP in practice, and to explain the conclusions that we have reached on many interpretive issues.

We expect to update this Handbook as needed based on developments in practice. You will find the most up-to-date version of this and other KPMG publications on KPMG's [Financial Reporting View](#).

Currently Effective Requirements

This Handbook takes an in-depth look at the application of ASC Topic 830, *Foreign Currency Matters*.

It provides our current interpretations, which are based partly on periodic, informal discussions with the FASB and SEC staffs. Our interpretations may be affected by future guidance issued by the FASB or its staff, the SEC staff, and others involved in the standard-setting and regulatory processes.

Organization of the Text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® to supplement our interpretive guidance, and illustrative examples that address the specific implementation issues we have identified.

New in 2024

In our January 2024 edition, we updated interpretive guidance related to the issuance of FASB Accounting Standards Updates (ASUs) and added or clarified other guidance as follows.

<i>Topic</i>	<i>Reference</i>
Additional guidance on changes in functional currency	2.021
New guidance on items to consider if an entity holds an investment in an entity domiciled in a country with significant economic and political uncertainty	3.012a
Additional guidance relating to what exchange rate to use, including guidance on alternative exchange rates	3.013, 3.014, 3.017, 3.017a, 3.018a and Example 3.4

New guidance on whether unamortized debt discounts, premiums and issuance costs are monetary or nonmonetary items	3.071a
Removal of guidance relevant before the adoption of ASU 2016-02, Leases	3.076
Addition of reference to Lease Handbook for operating lease with embedded foreign exchange component and removal of Example 5.1: Embedded Foreign Currency Derivative Instrument	5.012
Updated guidance on presentation of embedded foreign currency derivative instruments	5.015
Additional guidance on disclosure considerations if there are foreign entities with multiple exchange rates	7.024, 7.024a, 7.025
New guidance on the use of a currency other than the US dollar	7.032

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Section 1 - Overview of Accounting for Foreign Currency

1.000 FASB ASC Topic 830, *Foreign Currency Matters* (formerly FASB Statement No. 52, *Foreign Currency Translation*) provides accounting guidance for transactions denominated in a foreign currency, and for operations undertaken in a foreign currency environment.

1.001 In developing the guidance in ASC Topic 830, the FASB acknowledged that an entity may undertake different operations in different economic and currency environments, and that the financial position and results of these operations are best measured in the respective currency of the primary economic environment in which they take place. Statement 52, pars. 75, 78, and 97

1.002 To operationalize this approach, the FASB developed two concepts: ASC Section 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 and (b) combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.
- **Functional Currency:** 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. If this environment is a highly inflationary economy, the parent's functional currency should be used as if it were the entity's functional currency.

1.003 The concepts of foreign entity and functional currency are discussed further in Section 2, *Functional Currency*, of this guide.

1.004 The functional currency approach requires that two basic accounting tasks are addressed with respect to foreign currency:

- Measurement and recognition of foreign currency transactions of an entity in the entity's functional currency; and
- Translation of an entity's functional currency financial statements, if different from the reporting entity's reporting currency, into the reporting currency for preparing the reporting entity's (consolidated) financial statements.

1.005 A key distinction between measurement and translation under ASC Topic 830 is that the former captures a cash flow consequence due to changes in exchange rates while the latter aggregates financial statements of entities with different functional currencies, or measures an entity's financial statements in a reporting currency other than its functional currency and, thus, lacks a current cash flow consequence. Because of this

difference in cash flow consequence, measurement or remeasurement affects earnings and translation affects equity. The objectives of remeasurement and translation are to: ASC paragraph 830-10-10-2

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

1.006 Foreign Currency Transactions. Foreign currency transactions are transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions should be accounted for as follows: ASC paragraphs 830-20-25-1, 830-20-35-2

- At the date the transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction should be measured and recorded in the entity's functional currency using the exchange rate at which the transaction could be settled at the transaction date.
- At each balance sheet date, recognized monetary assets and liabilities that are denominated in a currency other than the entity's functional currency should be adjusted to reflect the exchange rate at which the related monetary item could be settled at that date.

1.007 Changes in the exchange rate increase or decrease the expected functional currency cash flows on settlement of a transaction and are reflected in the remeasurement of monetary assets and liabilities at each balance sheet date and on settlement. An entity should recognize changes in the exchange rate as foreign currency transaction gains or losses in current income, except for certain intercompany transactions and hedging relationships. Measurement and recognition of foreign currency transactions are discussed in Section 3, *Foreign Currency Transactions* of this guide.

1.008 Translation of Foreign Currency Financial Statements. To prepare consolidated financial statements, an entity translates all functional currency financial statements into a single reporting currency. The same applies if an entity uses different currencies for reporting purposes and for its functional currency.

1.009 If a foreign entity's functional currency (i.e., the currency of its primary economic environment), differs from the reporting entity's reporting currency, the entity's functional currency cash inflows and outflows can be viewed as economic hedges of each other, and only the reporting entity's net investment in the foreign entity is exposed to exchange risk. Therefore, the FASB concluded that the objectives of ASC Topic 830 are best achieved by translating (a) assets and liabilities at the exchange rate applicable to dividend remittances at the balance sheet date, and (b) revenues, expenses, gains, and losses at the exchange rate at the date on which those elements are recognized or at an appropriately weighted average exchange rate for the period of operations. The use of an

end-of-period exchange rate for revenues, expenses, gains, and losses was rejected because it would have required restating prior interim periods or recording a catch-up adjustment in income if rates change. ASC Section 830-30-45

1.010 Under the ASC Topic 830 translation approach, the effect of exchange rate changes on net assets and net income results in translation adjustments. These translation adjustments do not affect reporting currency cash flows until the respective foreign entity is sold or liquidated. The translation adjustments can be viewed as unrealized gains or losses and therefore are not reported in results of operations, but in other comprehensive income and accumulated in the translation adjustment component of equity until realized upon sale, exchange, or liquidation of the foreign entity. Section 4, *Translation of Foreign Currency Financial Statements*, of this guide provides additional guidance about the accounting for the translation adjustment component of equity upon the sale, exchange, or liquidation of a foreign entity. ASC paragraph 830-30-45-12

1.011 Sometimes an entity's books of record may not be maintained and its financial statements initially may not be prepared in its functional currency (e.g., if its functional currency is not the local currency of the entity's country of residence). Remeasurement of those financial statements into the entity's functional currency technically does not represent a translation of foreign currency financial statements as ASC Topic 830 uses that term, although the remeasurement may be done as part of the consolidation process. Remeasurement represents retroactive application of recognition and measurement principles for foreign currency transactions as discussed in Section 3. Translation of foreign currency financial statements is discussed in Section 4.

1.012 Foreign Currency Derivatives and Hedging Foreign Currency Risk. ASC Topic 815, *Derivatives and Hedging*, is the primary accounting standard for derivatives and hedging activities.

1.013 A fundamental principle of ASC Topic 815 as it relates to foreign currency hedging was to make the accounting for hedges of foreign currency exposures consistent with the accounting for hedges of other fair value and cash flow exposures. Thus, ASC Topic 815 permits hedge accounting for forecasted foreign-currency-denominated transactions hedged with foreign currency forward contracts or with any other foreign currency derivative contract. In addition, tandem or cross-currency hedging also is permitted. By contrast, conceptual application of a fundamental principle in ASC Topic 815 would have resulted in prohibiting hedge accounting for hedges of net investments in foreign operations, because designating a net investment in a foreign operation as a hedged item would be considered the same as designating a group of dissimilar assets and liabilities as a hedged item, which is not permitted for a fair value or cash flow hedge under ASC Topic 815. However, Statement 52 previously permitted hedge accounting for hedges of net investments in foreign operations, and practice in this area was well-established. Because ASC Topic 815 did not comprehensively reconsider the accounting provisions of Statement 52, hedge accounting for hedges of net investments in foreign operations is still permitted. In addition, even though ASC Topic 815 generally prohibits the use of non-derivative instruments as hedging instruments, this practice continues to be permitted for certain foreign currency hedges because such practice previously was

followed under Statement 52. Thus, although ASC Topic 815 was seeking consistency, the difference between the hedge accounting models applied to foreign currency exposures and the models applied to other exposures has been accepted. The accounting for foreign currency derivatives and for foreign currency hedges is discussed in Section 5, *Foreign Currency Derivatives and Hedging Foreign Currency Risk*, of this guide and section 11 of KPMG Handbook, [Derivatives and hedging](#).

1.014 Several other topics related to foreign currency transactions or translation of foreign currency financial statements require specific attention. ASC Topic 740, *Income Taxes*, provides guidance for the effect on income taxes of changes in exchange rates of a functional currency that differs from the currency in which the tax basis of assets and liabilities is denominated and of translation adjustments. These issues are discussed in Section 7, Foreign Operations of KPMG Handbook, [Accounting for Income Taxes](#). ASC Topic 830 and SEC rules and regulations require certain disclosures about foreign currency transactions and foreign operations, which are discussed in Section 7 Presentation and Disclosures, of this guide.

Section 2 - Functional Currency

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GENERAL PRINCIPLES

2.000 Under ASC Topic 830, *Foreign Currency Matters*, foreign entities within an enterprise that operate in different economic and currency environments may prepare financial statements in their respective functional currency. These functional currency financial statements are then translated into the enterprise's reporting currency for consolidation purposes.

2.001 Definition of Foreign Entity. A foreign entity is an operation (e.g., subsidiary, division, branch, joint venture, and so forth) whose financial statements are both prepared in a currency other than the reporting currency of the reporting enterprise and combined or consolidated with, or accounted for by, the equity method in the financial statements of the reporting enterprise. ASC Section 830-10-20

2.002 A foreign entity may have two or more distinct and separable operations (e.g., a division or branch). Each separate operation may be considered a separate foreign entity and should be evaluated to determine the appropriate functional currency (i.e., a distinct and separable operation). Stated another way, an entity may be disaggregated into more than one operation with different functional currencies. The concept of *distinct and separable operations* refers to the nature of the underlying operations and not the form of individual transactions that occur within the operations. An entity has more than one *distinct and separable* operation in a country when each operation is run as an independent and separate business with an ability to produce a full set of articulated financial statements that include all the accounts and transactions one would expect to find in the financial statements of such a business. However, it would not be appropriate, for example, to conclude that one operation holds only certain assets or liabilities (e.g., inventories, receivables, or debt) and another holds all other assets and liabilities and incurs all the expenses. Normally, distinct and separable operations are conducted in different economic environments. ASC paragraphs 830-10-45-5, 830-10-55-6

2.003 We believe that an enterprise should demonstrate all of the following conditions to conclude that an operation within an entity is distinct and separable:

- The activities are managed separately from the remainder of the entity as an integrated operation and the activities are distinguished from others within the entity;
- The assets and liabilities are distinguishable from other assets and liabilities;
- The operation holds all assets and liabilities relevant to the type of operation it purports to represent; and
- The operation is able to produce meaningful financial statements that include the assets of the operation as well as the funding for the assets and the relevant income statement effects.

We do not believe that a distinct and separable operation necessarily must meet the definition of a business under ASC Topic 805, *Business Combinations*, or an operating segment under ASC Topic 280-10, *Segment Reporting - Overall*.

2.003a Additionally, to the extent a foreign entity has operations that are included in two or more operating segments under ASC Topic 280, an enterprise should consider if that is an indicator that those operations are distinct and separable within that foreign entity. In addition to the guidance in paragraph 2.003, we believe an entity should consider what information related to the operating segments is available. For example, if the local financial statements issued by the foreign entity include segment data that allocates all assets, liabilities and equity of the foreign entity to the operating segments, and the parent entity maintains and tracks the foreign entity's cumulative translation adjustment based on the underlying operating segments, this may indicate that each of the operating segments within the foreign entity is distinct and separable.

2.004 Definition of Functional Currency. ASC paragraph 830-10-45-2 states:

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.

Selecting the functional currency is important because it is the basis for the entity to identify foreign currency transactions and to translate its financial statements.

2.005 The functional currency will not always be the currency of the country in which the foreign entity is located or the currency in which the accounting records are maintained (e.g., when the entity is merely an extension of the parent company). In that case, the functional currency of the foreign entity would be the functional currency of the parent company. ASC paragraph 830-10-45-4

2.006 Because multinational companies operate in numerous economic environments with multiple foreign currencies, the FASB concluded that it is necessary to recognize at least two broad classes of operations to determine the currency of the primary economic environment in which the entity operates. ASC paragraph 830-10-45-4

2.007 The first class is a foreign operation that is relatively self-contained and integrated within a particular country or economic environment. In that situation, the daily operations of the foreign operation do not depend on the economic environment of the parent's functional currency. Cash flows of the operation are generated and expended principally in a foreign currency and do not directly affect the parent company's cash flows. The foreign currency is the functional currency for this class of foreign operations. ASC paragraph 830-10-45-4

2.008 The second class is comprised of foreign operations that are primarily a direct and integral part of the parent company's operations. Daily operations of this class depend on the parent's economic environment and directly affect the parent's cash flows. The parent's functional currency is the functional currency for this class of foreign operations. ASC paragraph 830-10-45-4

2.009 The FASB did not provide unequivocal criteria to use in identifying the functional currency of foreign entities in all possible situations. The FASB concluded that establishing arbitrary criteria would achieve only a degree of superficial uniformity at the cost of reducing the relevance and reliability of the translated financial statements. Instead, the FASB provided economic factors for an enterprise to consider, individually and collectively, when determining its functional currency. ASC paragraph 830-10-45-3

2.010 ASC Topic 830 states that the functional currency of a foreign operation is, in principle, a matter of fact. In some situations, however, the facts may not identify clearly the functional currency, and management's judgment is required in determining the functional currency that most faithfully portrays the economic results of the entity's operations and, thereby, best achieves the objectives of translation (see Paragraph 1.005). Management is in the best position to obtain the pertinent facts and weigh their relative importance to determine the functional currency of an operation. Management's judgment is essential and paramount in this determination, provided only that it is not contradicted by the facts. ASC paragraphs 830-10-45-6, 830-10-55-4

2.011 ASC Topic 830 describes the economic factors that management should consider in determining the functional currency. None of these factors, which are listed in Paragraphs 2.012 through 2.017 along with examples of related indicators, are considered more significant than the others. These factors, and possibly others, should be examined individually and collectively to determine the appropriate functional currency. ASC paragraph 830-10-55-5

2.012 Cash Flow Indicators.

- **Foreign Currency as Functional Currency** – Cash flows generated by the foreign operation that relate to its individual assets and liabilities are primarily in the foreign currency and do not directly affect the parent's cash flows.
- **Parent's Functional Currency as Functional Currency** – Cash flows generated by the foreign operation that relate to its individual assets and liabilities have a direct effect on the parent's cash flows and are readily available for remittance to the parent.

2.013 Sales Price Indicators.

- **Foreign Currency as Functional Currency** – Sales prices of the foreign operation's products or services are determined more by local competition or government regulation than by worldwide competition and international prices and generally are not responsive on a short-term basis to changes in exchange rates.
- **Parent's Functional Currency as Functional Currency** – Sales prices of the foreign operation's products or services are determined more by worldwide competition and international prices and are responsive on a short-term basis to changes in exchange rates.

2.014 Sales Market Indicators.

- **Foreign Currency as Functional Currency** – There is an active local sales market for the foreign operation’s products or services, although there also might be significant amounts of exports.
- **Parent’s Functional Currency as Functional Currency** – There is no active local sales market for the foreign operation’s products or services; most of the foreign operation’s products or services are exported or sales contracts are denominated in the parent’s currency.

2.015 Expense Indicators.

- **Foreign Currency as Functional Currency** – The foreign operation uses primarily local labor, materials, and other costs to produce its products or render its services, even though there also might be imports from other countries.
- **Parent’s Functional Currency as Functional Currency** – The labor, materials, and other costs for the foreign operation’s products or services primarily come from the country in which the parent is located.

2.016 Financing Indicators.

- **Foreign Currency as Functional Currency** – The financing is denominated primarily in the foreign currency and cash flows generated by the foreign operation are sufficient to service existing and anticipated financing obligations. That indication would not change if the parent supplies additional financing for expansion, as long as the expanded foreign operation is expected to service the additional financing.
- **Parent’s Functional Currency as Functional Currency** – The financing is denominated primarily in the parent company’s currency, or cash flows generated by the foreign operation are generally insufficient to service existing and anticipated financing obligations.

2.017 Intercompany Transactions and Arrangements Indicators.

- **Foreign Currency as Functional Currency** – The foreign operation has a low volume of intercompany transactions and no extensive interrelationship with the parent. That indication would not change just because the foreign operation relies on the parent’s competitive advantages, such as patents and trademarks.
- **Parent’s Functional Currency as Functional Currency** – The foreign operation has a high volume of intercompany transactions and an extensive interrelationship with the parent. In other words, the foreign operation is merely an extension of the parent. Therefore, the parent’s currency generally would be the functional currency if the foreign entity is a shell corporation for

holding investments, obligations, intangible assets, etc., that could readily be carried on the parent's books.

Q&A 2.1: Functional Currency of Shell Company

Q. U.S. Parent Company A has a foreign subsidiary (Subsidiary B) whose functional currency is the local currency. Subsidiary B holds a U.S. dollar-denominated receivable and, therefore, is required to record transaction gains and losses on its U.S. dollar-denominated receivable in its income statement. Subsidiary B created wholly owned Subsidiary C for the sole purpose of holding the U.S. dollar-denominated receivable. What is the functional currency of Subsidiary C?

A. ASC paragraph 830-10-55-5(f)(2) states, "...the parent's currency generally would be the functional currency if the foreign entity is a device or shell corporation for holding investments, obligations, intangible assets, and so forth, that could readily be carried on the parent's or an affiliate's books." In this case Subsidiary B (the immediate parent of Subsidiary C), not Parent Company A, would be considered the *parent* in applying ASC paragraph 830-10-55-5. Therefore, the functional currency of Subsidiary C would be Subsidiary B's functional currency.

2.018 The basis for determining the functional currency of a foreign operation should not rest solely on the fact that the parent company exercises control or significant influence, or that the parent's currency is used for internal decision-making purposes. Economic facts and circumstances should be the basis for the functional currency. Management control, decisions, and resultant actions may indicate or create economic facts and circumstances and, therefore, are relevant in determining the entity's functional currency. However, management control, decisions, and resultant actions are not the sole factors that determine the functional currency of the foreign operation. ASC paragraph 830-10-55-7

2.019 Long-term considerations are more important than short-term considerations in determining the functional currency because the functional currency, once determined, should not change unless significant changes in facts and circumstances occur. For example, for a newly established foreign entity, economic factors during the start-up phase may point toward the parent's functional currency as the foreign entity's functional currency, but the foreign entity is anticipated to be relatively self-contained and integrated within the foreign economic environment once it is fully operational. In this case, the foreign currency should be the foreign entity's functional currency from inception.

2.020 ASC Topic 830 discusses how the functional currency of a foreign operation is determined by evaluating certain economic factors and, in part, by considering the functional currency of the parent company. However, it does not explicitly discuss how the economic factors and the functional currency of a foreign operation may be considered when determining the parent company's functional currency. This evaluation needs to be performed in situations such as when a holding company or intermediary

holding company (parent company) is established in one country for capital raising and exchange listing purposes, but has no other business operations other than its investment in operating entities domiciled within a different country or countries. When determining the parent company's functional currency in these cases, many of the indicators described in Paragraphs 2.012 through 2.017 may not be readily apparent. In these situations, it may be useful to consider the financing and intercompany transactions and arrangement indicators. However, these two indicators may not be determinative and may provide contradictory results. For example, a parent company may conduct most of its financing activities in the local currency, but may have a high volume of intercompany transactions with its foreign operations. Therefore, management's judgment is paramount when determining the functional currency of the parent company in these situations.

Example 2.1: Foreign Entity with Foreign Functional Currency

A foreign subsidiary of a U.S. corporation has a relatively self-contained and integrated operation in the local country. Local competition largely determines the sales prices of its products, which generally sell in the local market place. Product manufacture occurs in the local country using raw materials generally purchased from local country vendors. Thus, the functional currency for the foreign subsidiary would be its local currency.

If the subsidiary has some transactions and open account balances denominated in currencies other than its local currency, it must first remeasure those balances into the functional currency (i.e., the local currency) at the current rate, with any gain or loss included in net income. Only after the remeasurement of transactions and balances into the functional currency of the subsidiary are the financial statements of the subsidiary translated to the parent's reporting currency. The process of translating financial information to the parent's reporting currency results in translation adjustments that are accumulated in a separate component of stockholders' equity (i.e., accumulated other comprehensive income).

Example 2.2: Foreign Entity with Parent Company's Currency as Functional Currency

A foreign sales branch or subsidiary of a U.S. parent, which takes orders for the parent's merchandise, bills and collects for the sale of merchandise, has a local warehouse to facilitate timely delivery, is financed by the parent, and immediately remits to its parent all cash flows that it generates, would have the U.S. dollar as its functional currency. Receivables or payables of the branch or subsidiary denominated in currencies other than the U.S. dollar, including those denominated in its local currency, would be remeasured into the U.S. dollar at the current rate, and changes in the exchange rate would result in a transaction gain or loss to be included in net income.

Example 2.3: More Than One Functional Currency

Parent, a U.S. company, has two separate foreign operations in the same country. Branch A is a sales outlet for Parent's products. Most of its sales are in the local country and Branch A remits its net cash flows exclusively to Parent.

Division B manufactures and distributes its own products. Its manufacturing and distribution costs, as well as cash generated by those operations, are primarily in the local currency and have little, if any, direct effect on Parent's cash flows.

Based on the facts presented, Branch A's functional currency likely would be the U.S. dollar, whereas Division B's functional currency likely would be the local currency.

CHANGING THE FUNCTIONAL CURRENCY

2.021 Management's assessment of the economic facts is paramount in determining the functional currency of an operation. Once determined, it is difficult to change the functional currency. ASC paragraph 830-10-45-7 specifies that, once determined, the functional currency for a foreign entity should be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. The functional currency may change due to a specific identifiable event or as a result of changes over a period of time.

Except for functional currency changes related to highly inflationary economies, ASC Topic 830 does not provide guidance about identifying those significant changes. Generally, management should not change the functional currency unless the changes in economic facts and circumstances are so significant as to constitute new facts and circumstances. Thus, changes in the functional currency should be rare. Accordingly, the functional currency should not be changed if the changes in economic facts and circumstances are expected to be temporary. Nevertheless, management should regularly assess if there has been a significant change in economic facts and circumstances of each subsidiary.

Example 2.4: Change in Functional Currency

Company A established a foreign subsidiary approximately three years ago. At that time, the subsidiary functioned as a local manufacturer of Company A's products and sold those products to the local market. All manufacturing and distribution costs were incurred locally and earnings were retained to support the growth of the operation locally. Accordingly, Company A's management determined that the functional currency of the subsidiary was its local currency.

Currently, the subsidiary has ceased manufacturing in the local country and will function primarily as a foreign sales office and repair center. The subsidiary will purchase its

inventory from its parent in U.S. dollars and remit sales proceeds to Company A. The changes in the nature of the operations of the subsidiary indicate a different set of economic facts and circumstances that require a new determination of the functional currency.

2.022 If a foreign entity operates in a country that recently experienced economic turmoil, there may be significant changes in economic facts and circumstances that warrant reconsideration of the entity's functional currency. For example, severe economic problems could cause local currency cash flow sources to severely diminish compared with other currency cash flow sources. The SEC staff acknowledged that for a self-contained foreign entity whose functional currency used to be the local currency, these economic problems could indicate a change in functional currency. However, the enterprise would need to expect that these changes in the cash flow sources would be long-term to effect the change in functional currency. Conversely, cash flow limitations generally would not indicate a change in functional currency for a foreign entity that is an integral component or extension of the parent company's operations and whose functional currency, therefore, is the parent company's currency. The SEC staff expects a registrant's analysis to focus on factors that affect the specific foreign entity's cash flows. The 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. [SEC Division of Corporation Finance, Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, I.D.](#)

Q&A 2.2: Change in Functional Currency

Q. Foreign Parent A has a wholly owned sales financing subsidiary (S) in the United States. The primary economic environment in which S has historically operated resulted in the U.S. dollar being its functional currency. Substantially all of S's loan portfolio is denominated in U.S. dollars. In addition, all financing for S, other than notes payable to banks, represents advances from affiliates that are denominated in U.S. dollars. Notes payable to banks, however, are denominated in Parent A's currency. Due to write-downs and sales of assets, notes payable to banks now exceed total assets. Does the fact that a significant portion of S's balance sheet now consists of liabilities that are denominated in Parent A's currency require a change in the functional currency?

A. ASC Topic 830 indicates that the functional currency will normally be the currency of the economic environment in which cash is generated and expended by an entity. ASC paragraph 830-10-45-7 states in part that "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." Because a significant portion of S' liabilities continue to be U.S. dollar-denominated, all assets are denominated in U.S. dollars and all remaining activities continue to be denominated in U.S. dollars, S should continue to use the U.S. dollar as its functional currency.

Q&A 2.3: Change in Functional Currency

Q. Company ABC, a multinational U.S. company, has operations in foreign countries A, B, and C. All three operations have the U.S. dollar as their functional currency.

ABC initially established all three entities as sales offices. Over the past five years, the entity in country A added assembly operations and in the current fiscal year added a manufacturing facility. No significant economic changes have occurred for the entities in countries B or C since they were established. Earnings of these three locations have not been repatriated, and there is no plan to do so in the future. All three of the local currencies can be exchanged for U.S. dollars, but there currently is a low trade volume for the local currency of country A. Is it appropriate to change the functional currencies of these three entities to their local currencies?

A. While ASC Topic 830 does not provide guidance about how to apply the requirement that “significant changes in economic facts and circumstances” must be present to change the functional currency, the change in the facts and circumstances surrounding the entity in country A (e.g., added assembly operations and manufacturing capabilities) is significant enough to justify the change. However, there is no evidence to justify a change for the entities in countries B and C because no significant changes have been made to the operations of those entities since inception.

FOREIGN OPERATIONS IN HIGHLY INFLATIONARY ECONOMIES

2.023 A reasonably stable measuring unit is necessary to provide meaningful financial reporting using historical cost accounting. Any degree of inflation may affect the usefulness of information, but historical cost in a highly inflationary environment becomes irrelevant. Over time, assets carried at historical cost become relatively smaller compared with assets acquired recently at higher price levels (i.e., asset values *disappear* over time). The level at which inflation causes historical cost to become irrelevant for accounting purposes is a subjective one. ASC paragraph 830-10-45-13, Statement 52, par. 104

2.024 ASC Topic 830 requires that the financial statements of a foreign entity be remeasured as if the functional currency were the reporting currency of its parent, if the entity is in a country experiencing highly inflationary conditions. For purposes of this requirement, ASC Topic 830 defines a highly inflationary economy as one with a cumulative inflation rate of approximately 100% or more over a three-year period. This definition should not be considered a bright line test because the trend of inflation might be as important as the absolute rate. ASC paragraphs 830-10-45-11 through 45-13

2.025 Under ASC paragraph 830-10-45-12, the determination of a highly inflationary economy begins by calculating the cumulative inflation rate for the three-year period that

precedes the beginning of the reporting period, including interim reporting periods. If that calculation results in a cumulative inflation rate in excess of 100%, the economy should be considered highly inflationary in all instances. Projections of future inflation rates cannot be used to overcome the presumption that an economy is highly inflationary if the three-year cumulative inflation rate exceeds 100%. However, if the cumulative three-year inflation rate is less than 100%, the FASB believes historical inflation rate trends (increasing or decreasing) and other pertinent economic factors should be considered to determine whether the economy should be considered highly inflationary. For example, an economy in which the cumulative three-year inflation rate has been above 100% for a number of years and that now has a drop in inflation such that the latest cumulative three-year inflation rate drops below 100% should continue to be classified as highly inflationary until there is evidence to suggest that the drop below a 100% cumulative rate is other than temporary.

2.026 Inflation Index. An entity should use a broad-based measure of general inflation, similar to the U.S. Consumer Price Index (CPI), to measure inflation. It would generally be inappropriate to measure inflation based on another published index or industry- or company-specific data, even if the data more clearly encompass the inputs or outputs relevant to a specific entity. The International Monetary Fund (IMF) and service providers such as the Economist Intelligence Unit (EIU) publish inflation statistics.

2.027 Determining the Three-Year Period. An enterprise should compute the three-year cumulative rate of inflation using the most current information. The enterprise should use the three-year period that ends with the beginning of the current interim period, and it should recognize the fact that an economy became highly inflationary in the quarter in which that event occurs (i.e., the current interim period). Enterprises should not wait until their year-end to recognize the change. ASC paragraph 830-10-45-12

2.028 End-of-Period versus Average-for-the-Period Rate. ASC Topic 830 does not specify whether an entity should use end-of-period or average-for-the-period rates of inflation; therefore, judgment should be applied. In conjunction with the assessment of the trend of inflation, either the end-of-period or average-for-the-period rates may be used as long as the method is used consistently.

2.029 Computing Cumulative Inflation. Cumulative inflation over a three-year period should be computed on a compounded basis by: (1) adding 1.00 to the inflation rate in each year (expressed as a decimal), (2) multiplying the three rates together, and (3) deducting 1.00 from the product.

Example 2.5: Computing Cumulative Inflation Rate

“International Financial Statistics” (October 2002), published by the International Monetary Fund, reported that Turkey had inflation rates in 1999, 2000, and 2001 of 64.9%, 54.9%, and 54.4%, respectively. The cumulative inflation for that three-year period is 294.4% $[(1.649 \times 1.549 \times 1.544) - 1 = 2.944 \text{ or } 294.4\%]$.

2.030 When compounded, an annual rate of approximately 26% results in cumulative inflation of 100% over a three-year period. Assume that the CPI was 100 at January 1, 20X1, and the inflation rate was 26% per year for 20X1, 20X2, and 20X3. The CPI at December 31, 20X3 would be 200 ($100 \times 1.26 \times 1.26 \times 1.26$), not 178 ($100 + 26 + 26 + 26$). Thus, the cumulative inflation for the three-year period ending 20X3 would be 100%.

2.031 AICPA International Practices Task Force. In practice, the highlights of meetings of the AICPA International Practices Task Force are a source of information for the assessment of an economy as highly inflationary.

2.032 Inflation and Devaluation. According to economic theory, in the long run, currencies with high inflation rates are expected to decline in value compared with currencies with low inflation rates. Additionally, economies with currencies that are devalued relative to other currencies may experience higher inflation as a result of increased import prices measured in the local currency. However, the extent to which a currency is devalued against other currencies during a period has no direct effect on the assessment of whether the economy is highly inflationary. Whether an entity operates in a highly inflationary economy must be assessed based on the inflation in the currency of the primary economic environment in which the entity operates.

Q&A 2.4: Fixed Exchange Rate

Q. Foreign Country A's government maintains a fixed exchange rate between the local currency and the U.S. dollar. Would the existence of a fixed exchange rate obviate the requirement under ASC Topic 830 to account for Country A as a highly inflationary economy once Country A experiences a three-year cumulative inflation rate of 100% or more?

A. No. Under ASC Topic 830, a highly inflationary economy is one that experiences a cumulative rate of inflation of 100% or more over a three-year period. The fact that Country A's government fixed the exchange rates does not determine whether an economy is highly inflationary. However, high inflation at the foreign entity level, combined with a fixed exchange rate to the parent's reporting currency, will result in the foreign entity's assets representing a higher percentage of the parent's consolidated assets, as long as the situation continues to exist.

Q&A 2.5: Functional Currency Different from Local Currency

Q. A non-U.S. parent company prepares its financial statements in accordance with U.S. GAAP using its local currency as the reporting currency. It has a subsidiary located in a country with a highly inflationary economy. The subsidiary's functional currency has been the U.S. dollar. Should the subsidiary use its parent's reporting currency or the U.S. dollar as its functional currency?

A. The U.S. dollar. Because the subsidiary's functional currency is the U.S. dollar, it measures inflation in U.S. dollars and, therefore, it does not operate in a highly inflationary economy.

2.033 Highly Inflationary Economy in Multilevel Group. In a multilevel group the requirement that the financial statements of a foreign entity in a highly inflationary economy be remeasured as if the functional currency were the reporting currency of the parent should be applied on a step-by-step basis. That is, the reporting currency of the foreign entity's immediate parent, which we would expect also would be the immediate parent's functional currency, should be used as if it were the foreign entity's functional currency, as long as this currency is of a non-highly inflationary economy. ASC paragraph 830-10-45-11

Q&A 2.6: Highly Inflationary Economy in Multilevel Group

Q. U.S. Parent Company A has a foreign subsidiary (Subsidiary B) whose reporting/functional currency is the local currency. Subsidiary B in turn has a subsidiary (Subsidiary C) in a highly inflationary economy. What currency should Subsidiary C use as if it were its functional currency for remeasurement purposes?

A. ASC paragraph 830-10-45-11 states that the financial statements of a foreign entity in a highly inflationary economy should be remeasured "as if the functional currency were the reporting currency." In a multilevel group, the reporting currency should be interpreted to be the reporting currency of the immediate parent. Therefore, Subsidiary C's financial statements should be remeasured into the reporting/functional currency of Subsidiary B and then consolidated into Subsidiary B's financial statements. Subsidiary B's consolidated financial statements then would be translated and consolidated into Parent Company A's financial statements.

Section 3 - Foreign Currency Transactions

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GENERAL

3.000 Definition. The glossary in ASC paragraph 830-20-20 states that foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. For example, for an entity whose functional currency is not the U.S. dollar, a transaction denominated in U.S. dollars is a foreign currency transaction. ASC paragraph 830-20-05-2

Example 3.1: Foreign Currency Transactions

A U.S. company whose functional currency is the U.S. dollar borrows 1,000,000 British pounds from a bank in the United Kingdom in the form of a note payable bearing interest at 10% per annum. This is a foreign currency transaction entered into by the U.S. company resulting in recognition of monetary assets and liabilities denominated in a foreign currency (cash, note payable, and interest payable).

A wholly owned Japanese subsidiary of a U.S. company purchases \$2,000,000 of blue jeans from its U.S. parent for which it issues a note denominated in U.S. dollars. The functional currency of the Japanese subsidiary is the yen. The purchase is a foreign currency transaction of the Japanese subsidiary resulting in recognition of nonmonetary assets (inventory) and a monetary liability denominated in a foreign currency (note payable).

3.001 If a foreign currency transaction involves only cash flows of foreign currencies that occur at the date the transaction is recognized (e.g., acquisition of nonmonetary assets like inventory for foreign currency cash), the accounting issue is measurement of the transaction at that date. However, if a foreign currency transaction involves cash flows of foreign currencies that occur after the date the transaction is recognized (e.g., acquisition of nonmonetary assets for foreign currency amounts payable in three months), the transaction will result in recognition of one or more monetary assets or liabilities denominated in a foreign currency. Thus, the accounting issue is not only measurement at the date the transaction is recognized, but also remeasurement of the monetary assets or liabilities at the end of each reporting period until settlement. Remeasurement is also required for foreign currency cash on hand.

3.002 A monetary asset is 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. A monetary liability is an obligation to pay a sum of money, the amount of which is fixed or determinable without reference to future prices of specific goods or services. (ASC Section 255-10-20) Examples of monetary assets and liabilities denominated in a foreign currency include the following for a company whose functional currency is the U.S. dollar or any currency other than the Japanese yen:

- A loan payable in Japanese yen;
- Cash balances denominated in Japanese yen;

- Accounts receivable denominated in Japanese yen; and
- Investments in debt securities classified as held-to-maturity denominated in Japanese yen.

3.003 ASC paragraphs 830-10-45-18 and 255-10-55-1 through 55-13 provide further guidance for the classification of assets and liabilities as monetary or nonmonetary.

3.004 Accounting for Foreign Currency Transactions. ASC paragraphs 830-20-15-2, 830-20-25-1, 830-20-30-1, and 830-20-35-2, as amended by ASC Topic 815, *Derivatives and Hedging*, prescribe the following measurement guidance for foreign currency transactions (other than derivative instruments – see Section 5, *Foreign Currency Derivatives and Hedging Foreign Currency Risk*) of an entity: ASC paragraph 830-20-35-1

- At the date the transaction is recognized, each asset, liability, or instance of revenue, expense, gain, or loss arising from the transaction should be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date.
- At each balance sheet date, recorded balances of monetary assets and liabilities that are denominated in a currency other than the functional currency of the recording entity should be adjusted to reflect the current exchange rate.

3.005 Foreign Currency Transaction Gains and Losses. If a transaction results in recognition of monetary assets or liabilities, changes in currency exchange rates between the currency in which a transaction is denominated and the functional currency represent increases or decreases in the expected amount of functional currency-equivalent cash flows upon transaction settlement. These increases or decreases represent foreign currency transaction gains or losses that an entity generally records in net income. Transaction gains and losses arise when monetary assets and liabilities are denominated in a currency other than the functional currency and the exchange rate between those currencies changes. If the entity participating in the foreign currency transaction were a subsidiary of another entity (the reporting enterprise), the reporting enterprise also would report that foreign currency transaction gain or loss (after translation) in its consolidated income statement. There are certain exceptions to including gains and losses for foreign currency transactions in net income. Those exceptions relate to certain intercompany transactions and certain hedging transactions, and are discussed beginning in Paragraphs 4.073 and 5.018, respectively. ASC paragraph 830-20-35-1

3.006 A subsidiary whose functional currency is not the U.S. dollar may enter into transactions denominated in U.S. dollars, which may be the functional currency of its parent company. Changes in the relevant currency exchange rates between the transaction date and the settlement date of the transaction will result in foreign currency transaction gains and losses in the U.S. GAAP financial statements of the subsidiary. These transaction gains and losses are not eliminated in the parent company's consolidated financial statements. Statement 52, pars. 96, 111

Example 3.2: Foreign Currency Transaction – Purchase of Equipment

ABC Corp., (a U.S. manufacturer) purchases a specialized machine on account from a foreign company on May 1, 20X1 for a foreign currency (FC) denominated amount of FC1,500,000. The U.S. manufacturer remits the purchase price to the foreign company on June 15, 20X1. On May 1, 20X1 and June 15, 20X1 the currency exchange rates between the foreign currency and the U.S. dollar were \$0.90/FC and \$0.80/FC, respectively.

ABC would record the following entries to recognize the purchase price of the machine and the subsequent payment on account:

May 1, 20X1:

Machinery	\$1,350,000	
Accounts Payable		\$1,350,000

To record the purchase of a machine for FC1,500,000 at a currency exchange rate of 0.90.

June 15, 20X1:

Accounts Payable	\$1,350,000	
Cash		\$1,200,000
Foreign currency transaction gain		\$150,000

To record the payment of the accounts payable for FC1,500,000 at a currency exchange rate of 0.80. The change in the rate of exchange between the foreign currency and the U.S. dollar from May 1, 20X1 to June 15, 20X1, resulted in a foreign currency transaction gain recognized in net income. ABC calculated this gain as follows: $FC1,500,000 \times (0.90 - 0.80)$. Alternatively, ABC could have remeasured the accounts payable at the current exchange rate resulting in a foreign currency transaction gain recognized in net income, and then ABC could have paid the accounts payable. It is important to note that equipment is a nonmonetary asset that is denominated in the functional currency of the purchaser (i.e., US\$, using the relevant exchange rate at the date of acquisition).

3.007 Questions may arise about whether foreign currency transaction gains or losses stemming from individual transactions that constitute part of a larger, more broadly defined transaction may be deferred on the balance sheet until the broad transaction is completed. Under ASC Topic 830, *Foreign Currency Matters*, an individual foreign currency transaction that is not part of a hedging relationship (see Section 5) is an economic event subject to income statement recognition. Therefore, transaction gains or losses cannot be deferred until the larger, more broadly defined transaction is completed.

Q&A 3.1: Individual Foreign Currency Transactions as Part of a Larger Transaction

Q. Multinational Corp. operates in three major business groups through 50 direct and indirect subsidiaries throughout the world. Multinational Corp. is undergoing an internal realignment to organize its legal structure along business lines. As a result of the realignment, numerous debt and cash movements have taken place that, along with changes in currency exchange rates, have created foreign exchange gains. The company believes it is facing potential future foreign exchange losses and, therefore, proposes to defer the foreign exchange gains to offset expected losses. Is this acceptable?

A. Multinational Corp.'s proposal is not acceptable because ASC Topic 830 prohibits the deferral of foreign exchange gains and losses, except for certain intercompany and hedging transactions.

3.008 Intercompany Foreign Currency Transactions. Intercompany foreign currency transactions that are not of a long-term investment nature affect functional currency cash flows and are accounted for like foreign currency transactions with outside parties. That is, foreign currency transaction gains and losses are included in determining net income of both the foreign operation and the reporting enterprise. However, ASC subparagraph 830-20-35-3(b) indicates that gains and losses are not included in determining net income for intercompany transactions that are of a long-term investment nature (i.e., if 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. See Paragraph 4.073 for guidance on determining whether an intercompany foreign currency transaction is of a long-term investment nature. ASC paragraph 830-20-35-4

Q&A 3.2: Intercompany Foreign Currency Transactions

Q. ABC Corp.'s foreign subsidiary uses the local currency as its functional currency. ABC uses the U.S. dollar as its functional currency. The subsidiary has a U.S. dollar-denominated intercompany payable to ABC that is not considered to be of a long-term investment nature. Because of a weakening U.S. dollar, the subsidiary will generate a foreign currency transaction gain on settlement of the intercompany payable to ABC. How should the gain realized from settling the intercompany payable be treated in the subsidiary's financial statements and in ABC's consolidated financial statements?

A. ASC paragraphs 830-20-35-4 and 830-20-40-1 indicate that intercompany foreign currency transactions that are not of a long-term investment nature affect functional currency cash flows and should be accounted for like any other foreign currency transaction – i.e., the transaction gain or loss is included in determining net income.

Accordingly, the foreign subsidiary should report the transaction gain from settling the intercompany payable in its separate local currency income statement (U.S. GAAP basis).

Additionally, because the intercompany payable to ABC is not considered to be of a long-term investment nature, the transaction gain should also be reported (after translation) in ABC's consolidated income statement. The gain, from a consolidated standpoint, represents the increase in the net assets available as a result of spending less foreign currency cash to settle the U.S. dollar-denominated obligation of the foreign subsidiary. It is important to note that, holding all other factors constant, translating the subsidiary's local/functional currency financial statements, which will be consolidated with ABC's financial statements, results in an equal and offsetting foreign currency translation adjustment in other comprehensive income. This is discussed further in Paragraph 4.017.

3.009 When an intercompany foreign currency transaction is of a long-term investment nature, ASC subparagraph 830-20-35-3(b) and paragraph 830-20-35-4 indicate that the resultant foreign currency gains or losses should be reported in the same manner as translation adjustments (i.e., accumulated in other comprehensive income) when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting enterprise's financial statements. However, that guidance does not permit recognition of such gains and losses in other comprehensive income in the separate stand-alone financial statements of either party to the intercompany transaction.

Example 3.3: Intercompany Foreign Currency Transaction in Stand-Alone Financial Statements

ABC Corp.'s foreign subsidiary uses the local currency as its functional currency. ABC uses the U.S. dollar as its functional currency. The subsidiary has a U.S. dollar-denominated intercompany loan that is of a long-term investment nature. In the stand-alone U.S. GAAP financial statements of the subsidiary, the U.S. dollar intercompany loan is remeasured into its functional currency using the period-end currency exchange rate, and the foreign currency transaction gain or loss resulting from this remeasurement is included in the subsidiary's net income. However, in ABC's consolidated financial statements, the gain or loss is reclassified to other comprehensive income. Consistent with ASC paragraph 830-20-35-4, this is based on the concept that intercompany transactions and balances for which settlement is not planned or anticipated in the foreseeable future are considered to be part of the net investment of the reporting entity. This is discussed further in Paragraph 4.073.

3.010 Interest Payments on Intercompany Loan of a Long-Term Investment Nature.

When the terms of an intercompany loan require periodic payments of interest, the loan may be considered of a long-term investment nature, under ASC subparagraph 830-20-35-3(b), as long as settlement of the principal balance is not anticipated or planned in the foreseeable future. However, the interest payable or receivable would not be considered of a long-term investment nature and, therefore, the effects of currency exchange rate changes on the interest balances would be recognized in net income as foreign currency transaction gains or losses.

3.011 Construction of Asset – Foreign Currency Transaction Gains and Losses. A company financing the cost of constructing a building with a loan denominated in a foreign currency may be capitalizing interest incurred as part of the cost of the building in accordance with ASC Subtopic 835-20, *Interest – Capitalization of Interest*. AICPA Technical Practice Aid 2210.27, *Construction of Asset—Foreign Currency Transaction Gains/Losses*, indicates that even though the company obtained the loan to construct the building, the foreign currency transaction gains and losses on the principal amount of the loan are not considered part of the cost of the building, but are included in determining net income each period in which the currency exchange rate fluctuates. The amount of interest to be capitalized is the functional currency equivalent amount of interest expense. TPA 2210.27

3.012 Income Statement Classification of Foreign Currency Transaction Gains and Losses. Realized and unrealized gains and losses on the foreign currency transactions ordinarily are included in net income as transaction gains and losses, as required by ASC Topic 830. However, ASC Topic 830 and other related interpretative guidance do not address the classification of foreign currency transaction gains and losses on the face of the income statement, except that the aggregate transaction gain or loss is presented in the income statement or disclosed in the notes thereto. ASC paragraph 830-20-45-1 and 830-20-50-1

3.012a Economic and Political Uncertainty. If an entity holds an investment in an entity domiciled in a country with significant economic or political uncertainty, there are additional foreign currency matters for consideration. Some of those considerations and the location of additional related guidance follow.

Topic	Guidance
Exchange rate to be used for foreign currency transactions	Section 3.014 – 3.018a, Example 3.4, Section 4.008 – 4.012, Q&A 4.1
Distinguishing between foreign exchange and credit losses	Section 7.001
Change in exchange rates after the balance sheet date	ASC Subtopic 855-10
Impairment and/or lower of cost or market write-downs of inventory, long-lived assets, equity method investments, goodwill	Section 3.051 – 3.053, 4.032 – 4.035
Consolidation and equity method considerations	Section 4.041 – 4.042, Question 2.5.70 of KPMG Handbook, Consolidation

Presentation of foreign currency denominated cash and cash equivalents as restricted cash	Question 6.4.10 of KPMG Handbook, Statement of cash flows
Disclosures	Section 7.011 – 7.015, 7.023 – 7.025, Example 7.2

EXCHANGE RATE

3.013 An exchange rate is defined in Topic 830 as the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. Foreign currency transactions should be recorded in the functional currency at the exchange rate at which a particular transaction could be settled at the transaction date. At each subsequent balance sheet date, the current rate is the rate at which the related receivable or payable could be settled at that date, generally the market spot rate. Different exchange rates may apply to different types of transactions.

3.014 Temporary Lack of Exchangeability. ASC paragraph 830-20-30-2 specifies that if exchangeability between two currencies is temporarily lacking at the transaction or balance sheet date, the rate that should be used is the first subsequent rate at which exchanges could be made. ASC paragraph 830-30-55-1 illustrates this concept with an example of a foreign entity in Israel as follows:

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

In this example, exchangeability was temporarily lacking and the rate established as of January 3, 1989, the first subsequent rate, is the appropriate rate to use for translating the December 31, 1988 financial statements. Even though ASC paragraph 830-30-55-1 is written for translation of financial statements, the same approach should be used for remeasuring foreign currency transactions when there is a temporary lack of exchangeability at the transaction or remeasurement date. If another rate applies to a

particular transaction, such as a preference or penalty rate (see Paragraph 3.016), then that rate should be used for remeasurement if the transaction is subject to, and will qualify for, that rate.

3.015 The term *first subsequent rate* should not be interpreted literally as the rate of the *first* exchange transaction that took place after the balance sheet date. An enterprise should apply judgment and use its standard procedures to determine the appropriate exchange rate. A low trading volume is not evidence of *lack of exchangeability*. Therefore, absent evidence that large or additional transactions could not occur, generally the rate at the first date at which exchange activity took place should be used, even if such activity was limited. AICPA International Practices Task Force, Highlights of the November 20, 2001 Meeting, Item XXVI (as of 1/14/02)

3.016 Preference or Penalty Rates. In unusual circumstances, preference or penalty rates that apply to collection or settlement of foreign currency-denominated assets or liabilities may affect the remeasurement of foreign currency monetary amounts (e.g., foreign currency-denominated cash or receivables). Foreign governments sometimes provide that foreign currencies (including U.S. dollars) needed to settle certain types of transactions may be obtained at a rate that is either favorable (a preference rate) or less favorable (a penalty rate) than the rate that would apply to other transactions, including a remittance of dividends to a foreign investor. For example, a foreign country's government might provide that U.S. dollars or other foreign currencies needed to pay for imports of essential raw materials can be purchased at a rate of \$1 = LC10 (local currency) at a time when the free market rate is \$1 = LC12. Another country's government might attempt to discourage exports of certain scarce commodities by providing that U.S. dollars received for them can be converted only at a rate of \$1 = LC10 when the market rate is \$1 = LC12.

3.017 The use of a preference or penalty rate as the current rate is appropriate for remeasurement if a determination is made that the foreign currency-denominated monetary item is subject to, and will qualify for, that preference or penalty rate.

3.017a An entity should consider the following factors to determine if remeasurement at a preference rate (instead of a free market rate) is appropriate.

- Recent government announcements, laws and regulations;
- Legal interpretations of government announcements, laws and regulations;
- The entity's analysis of its eligibility for preference rates as well as the types of transactions that would be eligible;
- The entity's recent ability, and expected future ability, to obtain foreign currency through preference rates for which it is eligible, as well as the volume and nature of those transactions;
- The probability that a preference rate will be used to exchange a foreign currency-denominated monetary item for USD, including the entity's intent to use the preference rate for particular types of transactions; and

- Successful or unsuccessful attempts by other market participants to obtain foreign currency through the preference rates the entity is eligible for and intends to use.

Entities should consider all facts and circumstances when evaluating which rate(s) to use for remeasurement, and the same conclusion would not necessarily apply to all entities, or for all monetary assets and liabilities of a particular entity.

Example 3.4: Use of Preference Rate in Remeasurement

A foreign entity whose functional currency is the U.S. dollar holds foreign currency (FC) denominated cash of FC1,000 at the balance sheet date. That cash is converted to U.S. dollars at a preference rate of US\$1 = FC10 (when the general rate is US\$1 = FC12) and used to satisfy a U.S. dollar obligation before the financial statements are issued. The subsequent conversion provides evidence that the appropriate current exchange rate for remeasuring the foreign currency-denominated cash at the balance sheet date is the preference rate that existed at the conversion date rather than the general rate of US\$1 = FC12. If evidence does not exist that the foreign currency-denominated cash is subject, and will qualify, to be converted at the preference rate, the cash should be remeasured at the general rate. The effect of the preference rate would be recognized when conversion occurs.

3.018 Black Markets. A black market for foreign currency may exist in countries with restrictive foreign exchange controls. Acquisition of foreign currency on such markets usually represents a violation of government regulations. Businesses do not normally acquire foreign currency on such markets. Therefore, using black market rates to remeasure foreign currency transactions is not appropriate.

3.018a Alternative Exchange Rate. Certain countries may place limitations on exchanging local currency for foreign currency. An entity may try to circumvent these limitations by performing legal trades that allow it to obtain the foreign currency. For example, an entity may purchase securities in the local market using the local currency and then sell those securities in another market for U.S. dollars. This purchase and sale creates an implied exchange rate, which may be referred to as a blue-chip rate or parallel rate. We believe such a rate does not meet the definition of an exchange rate because it is not a direct exchange of currencies at a particular time. Therefore, it cannot be used to measure transactions in a currency other than the entity's functional currency.

EQUITY SECURITIES

3.019 Equity Securities. The following table summarizes the foreign currency impact for equity securities.

Investment	Impact of foreign currency denomination
Investment is accounted for by the equity method	Subject to foreign currency translation as discussed in Section 4, <i>Translation of Foreign Currency Financial Statements</i> .
Investment in entity that is consolidated	Subject to foreign currency translation as discussed in Section 4, <i>Translation of Foreign Currency Financial Statements</i> .
Investment in equity securities in the scope of Topic 321	Initially measured and recorded in the functional currency at the exchange rate at the transaction date. The subsequent measurement depends on whether they have a readily determinable fair value and, if not, whether the investor elects the measurement alternative.

ASC Topic 321 excludes from its scope preferred stock that by its terms either must be redeemed by the issuer or is redeemable at the option of the investor. Such instruments are considered debt securities according to the glossary definition in ASC Section 320-10-20. See section 2.1 of KPMG Handbook, [Investments](#), for additional guidance on what investments are outside the scope of ASC Topic 321.

3.019a Equity Securities for which the Measurement Alternative is Not Elected

Equity securities are subsequently measured at fair value if they:

- have readily determinable fair values; or
- do not have readily determinable fair values and the measurement alternative in ASC paragraph 321-10-35-2 is not elected.

The fair value of the security is remeasured at the current exchange rate to determine the gain or loss to be recorded in net income. Importantly, the measurement of equity securities is a fair value measurement issue, and not an ASC Topic 830 measurement issue. These securities are not subject to an impairment model.

3.019b Equity Securities for which the Measurement Alternative Is Elected. If equity securities do not have readily determinable fair values, an entity can elect to apply the measurement alternative in ASC paragraph 321-10-35-2. Under this alternative, securities are subsequently measured at cost less impairment (if any). However, if an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, the security is measured at fair value under ASC Topic 820 at the date that the observable transaction for the identical or similar security took place. If an entity concludes that an equity security is impaired, it writes down the investment to fair value and recognizes the writedown in net income.

ASC paragraph 830-10-45-18(a) indicates that foreign currency denominated equity securities accounted for using the measurement alternative are nonmonetary assets that are measured at historical exchange rates and do not give rise to transaction gains or losses. ASU 2019-04 clarified that the historical exchange rate used is as of the later of:

- A: the acquisition date; or
- B: the most recent date on which the equity security was adjusted to fair value due to:
 - observable price changes in orderly transactions for a similar investment of the same issuer; or
 - impairment.

Therefore, if the carrying amount of an equity security is adjusted due to item B, the exchange rate at that date is used to measure the fair value of the equity security. The difference between a security’s functional-currency-equivalent fair value (based on the current exchange rate) on the date of remeasurement and the security’s carrying amount (based on the historical exchange rate) is reported in net income.

Example 3.5: Foreign Currency-Denominated Equity Security without a Readily Determinable Fair Value

ABC invests in foreign currency denominated shares issued by XYZ Company. The shares were acquired for LC1,000 when the exchange rate was LC1 = US\$1. The shares are not quoted and do not have a readily determinable fair value. ABC elects to measure the securities using the measurement alternative in ASC paragraph 321-10-35-2.

ABC obtains transaction price information for a third-party sale of identical shares of XYZ. Because it elected the measurement alternative, ABC adjusts the carrying amount of the XYZ shares to reflect their fair value at the date this observable transaction for the identical shares takes place. The fair value of the observable transaction is LC800. The exchange rate at the date of the observable transaction is LC1 = US\$0.9. Therefore, the fair value of ABC’s investment in XYZ at the date of the measurement is US\$720, resulting in a \$280 reduction in the investment’s carrying amount.

ABC records the following journal entry:

Net income	US\$280	
Investment in XYZ		US\$280

DEBT SECURITIES

3.020 Trading and Available-for-Sale Debt Securities. Trading and available-for-sale debt securities accounted for under ASC Subtopic 320-10 are measured at fair value. Changes in fair value are included in net income (for trading securities) or in other comprehensive income until realized (for available-for-sale securities).

These debt securities are nonmonetary assets and do not give rise to transaction gains or losses. However, for foreign currency-denominated debt securities, the change in fair value expressed in an entity's functional currency is the total of (1) the change in market price of the security as expressed in the foreign currency due to factors such as changes in interest rates and credit risk, and (2) the change in the currency exchange rate between the foreign currency and the entity's functional currency. The second component (the effect of changes in exchange rates) is not reported separately as a transaction gain or loss.

Trading securities are recorded at fair value with changes in fair value, including the effects of changes in exchange rates, reported in net income each reporting period. Therefore, they are not subject to an impairment model.

3.020a Available-for-Sale Debt Securities – Prior to Adoption of ASU 2016-13. ASC paragraph 320-10-35-36 clarifies that the entire change in fair value of foreign currency-denominated available-for-sale debt securities including the effects of changes in exchange rates, should be included in other comprehensive income. ASC paragraphs 320-10-35-36 to 35-37. ASC Subtopic 320-10 prescribes how to determine (1) when a debt investment is considered impaired, (2) whether that impairment loss is other-than-temporary, and (3) the recognition of the other-than-temporary loss.

3.020b A debt investment is impaired if the fair value of the investment is less than its amortized cost basis. For debt investments denominated in a foreign currency, to compare a security's fair value to its amortized cost, an entity remeasures the fair value at the current exchange rate and remeasures the amortized cost at the historical exchange rate.

3.020c When debt securities classified as either available-for-sale or held-to-maturity are impaired, an entity is required to determine whether the decline in fair value below the amortized cost basis is other-than-temporary. ASC Topic 320, *Investments--Debt Securities*, provides a model for determining whether the impairment is other-than-temporary and recognizing and presenting the other-than-temporary impairments. ASC paragraphs 320-10-35-20 through 35-34E

3.020d The accounting for the impairment loss depends on whether (a) the entity intends to sell the security or it is more likely than not that the entity will be required to sell the security, or (b) neither of the circumstances described in (a) are present. An investor that holds an impaired foreign currency-denominated debt security cannot avoid concluding that an other-than-temporary impairment exists solely by asserting that:

- it has no intent to sell the security; and
- it is not more likely than not that it will be required to sell the security before recovery of its foreign currency-denominated cost basis (i.e., an other-than-temporary impairment may exist when the decline in fair value not expected to be recovered is attributable to changes in foreign exchange rates).

ASC paragraphs 320-10-35-33A through 35-33F

The following describes the foreign currency issues and accounting requirements for these scenarios:

- If the entity intends to sell the security or it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss (including an expectation that it will not recover the fair value decline due to foreign currency exchange rates), the difference between the functional-currency-equivalent fair value based on the current exchange rate on the date of measurement and the historical cost based on the historical exchange rate (i.e., the impairment loss) should be recognized in net income.
- If the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment should be separated into (a) the amount representing the credit loss and (b) the amount related to all other factors (including foreign currency exchange rates if the entity expects to recover the fair value decline due to foreign currency exchange rates). In this instance, the amount of the total other-than-temporary impairment related to the credit loss should be recognized in net income. The amount of the total other-than-temporary impairment related to other factors should be recognized in other comprehensive income.

To determine if a credit loss exists, an entity would use its best estimate of the present value of cash flows (based on the foreign currency amounts remeasured at the historical exchange rate) expected to be collected from the debt security, discounted at the instrument's effective interest rate, and would compare that amount to the security's amortized cost, which would also be based on the foreign currency amount remeasured at the historical exchange rate. This is one of the methods that separates credit losses from losses attributable to other (non-credit) factors, including the decrease in fair value due to foreign currency exchange rates that is expected to be recovered. ASC Section 310-10-35

Example 3.5A: Other-Than-Temporary Decline in the Fair Value of a Foreign Currency-Denominated Available-for-Sale Debt Security

Assume an entity holds a debt security classified as available-for-sale that is denominated in a foreign currency. At the balance sheet date, the fair value of the security is US\$100 (in the entity's functional currency based on current exchange rates) and the amortized cost is US\$150 (in the entity's functional currency based on historical exchange rates). The entity concludes that the security is impaired and based on management's assessment of the facts and circumstances that the impairment is other-than-temporary.

When determining the impairment is other-than-temporary, management concludes that (a) it does not intend to sell the security and (b) it is not more-likely-than-not that the entity will be required to sell the security before recovering the amortized cost basis of

the security less any current-period credit losses. Management also expects to recover the fair value decline attributable to foreign exchange rates.

To recognize the other-than-temporary loss, management concludes that the US\$50 impairment loss comprises (a) US\$20, representing the amount attributable to the current-period credit loss (determined by comparing the entity's best estimate of future cash flows to amortized cost, with both based on foreign currency amounts remeasured using the historical exchange rate) and (b) US\$30, representing the amount attributable to all other factors, including foreign currency exchange rates. In this situation, the entity records an other-than-temporary loss of US\$20 in net income and US\$30 in other comprehensive income.

3.020e Impairment of Available-for-Sale Debt Securities – After Adoption of ASU 2016-13. ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, significantly changes how entities measure and recognize credit impairment for many financial assets. If an available-for-sale debt security is impaired (i.e., if the security's fair value is less than its amortized cost basis), an entity determines whether a credit loss exists. Generally, if a credit loss exists, an entity recognizes the credit loss using an allowance approach and recognizes subsequent changes in expected credit losses (favorable and unfavorable) immediately in net income by adjusting the allowance.

3.020f Paragraphs 320-10-35-35 and 830-20-35-6 require an entity to report the entire change in the fair value of foreign currency-denominated available-for-sale debt securities not related to the allowance for credit losses in other comprehensive income. The amount related to credit losses is reported as credit loss expense. See chapter 19 of KPMG Handbook, [Credit impairment](#), for additional guidance on accounting for credit impairment of available-for-sale debt securities, including guidance on when an entity recognizes in net income decreases in fair value due to changes in foreign exchange rates (Question 19.3.05).

3.021 Available-for-Sale Debt Securities Denominated in a Local Currency Index. Certain debt securities may be denominated in an index representing the value of the local currency, as of the date the index was established, adjusted for the cumulative effect of local inflation. Periodic interest payments and payment of the principal amount are settled in the local currency, based on the level of the index at the date of settlement. Gains or losses from the remeasurement of an index-denominated debt security should be included in net income as an adjustment to interest income using the retrospective interest method described in ASC paragraphs 320-10-55-11 through 55-13. The accounting for these gains and losses is outside the scope of ASC Topic 830 because they are not foreign currency gains or losses (i.e., changes in an inflation index are not foreign exchange rate changes). This guidance was not impacted by ASU 2016-13.

3.022 Under the retrospective interest method, income for the current period is measured as the difference between (a) the amortized cost at the end of the period and (b) the amortized cost at the beginning of the period, plus cash received during the period. The amortized cost amount is calculated as the present value of estimated future cash flows

using an effective yield, which is the yield that equates all past actual cash flows and current estimates of future cash flows to the initial investment. If the effective yield is negative, the amortized cost amount should be calculated using a 0% effective yield. Thus, the following procedures would be required for each reporting period:

- (1) Calculate the effective yield that equates all past actual cash flows and current estimates of future cash flows to the initial investment amount.
- (2) Using the rate calculated in step 1 (or 0% if the calculation results in a negative rate), calculate the present value of the estimated future cash flows. That amount represents the amortized cost at the end of the current reporting period.
- (3) Adjust the amortized cost balance to the amount calculated in step 2 with the offsetting amount recognized as interest income for the period.

3.023 After applying the retrospective interest rate method, the carrying amount of the available-for-sale debt security should be adjusted to fair value, with changes in fair value reported in other comprehensive income as discussed in Paragraph 3.020 (or paragraph 3.020e after the adoption of ASU 2016-13). An analogy for this accounting treatment can be made to ASC subparagraph 320-10-55-10(v) that describes an inflation bond in which the contractual principal amount is indexed to the inflation rate and the coupon rate is below that of a traditional bond of similar maturity. Further, ASC paragraphs 815-15-55-202 and 55-203 indicate that the rates of inflation and interest rates in an inflation bond are considered to be clearly and closely related. Therefore, the embedded derivative should not be separated from the host contract.

3.024 Held-to-Maturity Securities. Foreign currency-denominated debt securities classified as held-to-maturity in accordance with ASC Subtopic 320-10 are monetary assets and should be remeasured at the current currency exchange rate at the end of each reporting period. Transaction gains or losses should be included in net income in accordance with ASC Topic 830. Amortization of a discount or accretion of a premium on these debt securities should be recorded in the income statement at the average currency exchange rate during the period. ASC paragraph 255-10-55-1

Example 3.6: Held-to-Maturity Bond

ABC Corp., whose functional currency is the U.S. dollar, acquires a foreign currency (FC) denominated five-year bond bearing 5% annual interest with a nominal value of FC1,000 at a 10% discount, i.e., for FC900, on issuance on 12/31/20X1. This discount results in an effective interest rate of 7.47%. ABC intends to hold the bond to maturity. The exchange rate at the acquisition date is FC1 = US\$0.9, the average exchange rate during fiscal year 20X2 is FC1 = US\$0.85, and the exchange rate on 12/31/20X2 is FC1 = US\$0.8. For simplicity, the impact of the allowance for credit losses is not illustrated in this example. This results in the following amounts to be recognized during the first year of holding the bond:

	FC	US\$/FC	US\$
12/31/20X1:			
Acquisition	900	0.9	810
Fiscal year 20X2:			
Interest accrual	67	0.85	57
12/31/20X2:			
Interest payment	(50)	0.8	(40)
Transaction loss			(93)
Balance	917	0.8	734

ABC recognizes the investment in the bond at the acquisition date at US\$810, accrues interest income of FC67 during fiscal year 20X2 based on an effective interest rate of 7.47% and amortized cost of FC900 at the beginning of the year (remeasured at the average exchange rate into US\$57), and recognizes the interest payment of US\$40 on 12/31/20X2. Remeasurement of the amortized cost basis of the investment in the bond of FC917 into US\$ at the current exchange rate on 12/31/20X2 results in a transaction loss of US\$93, which is recognized in net income.

3.025 to 3.032 Not used.

3.033 Impairment of Held-to-Maturity Debt Securities – Prior to Adoption of ASU 2016-13. To determine whether a held-to-maturity debt security denominated in a foreign currency is impaired, an entity should first determine if the fair value of the debt security is less than its amortized cost. For this purpose, the entity could use the current exchange rates to remeasure both the fair value and the amortized cost amounts; alternatively, the entity could compare the fair value and the amortized cost amounts in the currency of denomination of the security.

If a security is impaired, the entity should evaluate if it expects to recover the amortized cost basis of the security. If the entity expects to fully recover the amortized cost basis of the security, then the security is not other-than-temporarily impaired. If the entity does not expect to fully recover the amortized cost basis of the security, then it recognizes the impairment loss as follows:

- The amount of credit loss should be recognized in net income. The entity may calculate the credit loss amount in foreign currency [for example, the difference between the present value of expected cash flows discounted at the security's effective interest rate and the security's amortized cost] and then remeasure it to functional currency using the current exchange rate.
- The amount of impairment loss attributable to other (non-credit) factors should be recognized in other comprehensive income. The entity may calculate this amount in foreign currency [as the difference between the security's fair value and its amortized cost basis less the credit loss amount] and remeasure it to functional currency using the current exchange rate.

- As noted in paragraph 3.024, held-to-maturity debt securities are monetary assets and should be remeasured at the current exchange rate at the end of each reporting period. The resultant foreign currency transaction gains/losses continue to be recognized in net income under Topic 830. Therefore, unlike an available-for-sale debt security, the transaction gains/losses resulting from the remeasurement of a held-to-maturity debt security using the current exchange rates are not considered in assessing whether the held-to-maturity debt security is other-than-temporarily impaired.

3.034 For debt securities classified as held-to-maturity, when an other-than-temporary impairment is recognized in other comprehensive income, the amount should be accreted from other comprehensive income (with a corresponding increase to the amortized cost of the debt security) over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows. That accretion should continue until the security is sold, the security matures, or there is an additional other-than-temporary impairment that is recognized in net income.

Example 3.7: Other-Than-Temporary Impairment in a Foreign Currency-Denominated Held-to-Maturity Debt Security

Assume an entity holds a debt security classified as held-to-maturity that is denominated in a foreign currency (FC). At the end of the previous reporting period, the amortized cost balance in foreign currency and in its US\$ functional currency are:

Amortized cost in FC	Fair value in FC	Exchange rate (US\$/FC)	Amortized cost in US\$	Fair value in US\$
1,000	1,000	0.9	900	900

At the end of the current reporting period, the information for the security is:

Amortized cost in FC	Fair value in FC	Exchange rate (US\$/FC)	Amortized cost in US\$	Fair value in US\$
1,000	800	1.1	1,100	880

At the end of the current reporting period, the security is impaired by FC200 because the amortized cost in FC is 1,000 and the fair value in FC is 800. If management does not expect to fully recover the amortized cost basis of the security, it must record an impairment loss.

Assume management determines that the FC200 impairment loss comprises (a) a credit loss of FC150 (determined by comparing the difference between present value of expected cash flows discounted at the effective interest rate and the amortized cost) and (b) noncredit loss of FC50 (determined by comparing the difference between fair value and amortized cost less credit losses). The entity recognizes the following amounts in the current reporting period:

The change in the fair value of the security remeasured at the current exchange rate:

- $US\$900 - (FC800 \times 1.1) = US\20
- Credit loss in net income – $FC150 \times 1.1 = US\$165$
- Impairment loss due to noncredit factors in other comprehensive income – $FC50 \times 1.1 = US\$55$
- Foreign currency transaction gain in net income – $FC1,000 \times [1.1 - 0.9] = US\200

The entity records the following journal entry to account for the other than temporary impairment of the held-to-maturity debt security.

Credit loss expense	US\$165	
Other comprehensive income	US\$55	
Foreign currency transaction gain		US\$200
Investment in held-to-maturity debt security		US\$20

3.034a Impairment of Held-to-Maturity Debt Securities – After Adoption of ASU 2016-13. ASU 2016-13 replaces the other-than-temporary impairment model with a requirement to recognize lifetime expected credit losses immediately when a financial asset is originated or purchased. See KPMG Handbook, [Credit impairment](#), for additional guidance on accounting for credit impairment. Even though the impairment model has changed, foreign currency-denominated debt securities classified as held-to-maturity continue to be monetary assets that are remeasured at the current exchange rate at the end of each reporting period. The associated allowance for credit losses is also considered a monetary item that is remeasured at the current exchange rate. Transaction gains or losses from remeasurement using the current exchange rate are included in net income.

3.035 Not used.

FINANCIAL ASSETS

3.036 Financial Assets Subject to Substantial Recovery Risk. ASC paragraph 320-10-25-5, as amended by ASC Topic 860, *Transfers and Servicing*, requires that debt securities, which contractually can be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, be classified as either available-for-sale or trading and subsequently measured at fair value. This classification principle is extended by ASC paragraph 860-20-35-2 to interest-only strips, other interests that continue to be held by a transferor in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of ASC Subtopic 815-10, *Derivatives and Hedging - Overall*.

3.037 An entity is not required to classify an investment with characteristics like a debt security under ASC paragraph 860-20-35-2 unless it has provisions that allow it to be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, as denominated in the foreign currency. An investment denominated in a foreign currency would not be subject to ASC paragraph 860-20-35-2 if the contract requires that substantially the entire invested foreign currency amount be repaid. ASC paragraph 860-20-35-4 explains that the requirement in ASC paragraph 860-20-35-2 does not apply to situations in which events that are not the result of contractual provisions (e.g., borrower default or changes in the value of an instrument's denominated currency relative to the entity's functional currency), cause the holder not to recover substantially all of its recorded investment.

3.038 Thus, determining whether a foreign currency-denominated financial asset exposes the holder to the risk of not recovering substantially all of its recorded investment should be made on a foreign currency basis and not on a functional currency basis. Financial assets that are not subject to substantial recovery risk and are monetary are remeasured at current exchange rates, with transaction gains or losses recorded in net income.

3.039 Sale of Financial Assets with Risk of Foreign Currency Fluctuation Retained.

If an entity transfers foreign currency-denominated financial assets to another entity but retains a beneficial interest in the transferred financial assets that represents the risk of foreign currency fluctuation, the beneficial interest is considered a form of continuing involvement by the entity and would need to be considered when determining whether the conditions of ASC paragraph 860-10-40-5 have been met to derecognize the financial assets. If it is determined that the conditions of ASC paragraph 860-10-40-5 have been met to derecognize the financial assets, the transaction should be accounted for as a sale. The retained beneficial interest representing the risk of foreign currency fluctuations is measured at fair value upon completion of the transfer and is subsequently accounted for at fair value with changes in fair value recognized in current income.

SALES OF FUTURE FOREIGN CURRENCY REVENUES

3.040 Entities enter into transactions to sell future revenues as a means to eliminate or reduce foreign currency risk. This occurs, for example, when (i) the proceeds of the sale are received in or immediately converted into the entity's functional currency, (ii) the future revenues sold are denominated in a currency other than that entity's functional currency, and (iii) there is little probability of recourse to the entity if the amount of future revenues does not equal or exceed the sales proceeds.

3.041 ASC paragraphs 470-10-25-1 and 25-2 and 470-10-35-3, indicate that the cash payment received from the investor on the sale of future revenues should be classified as debt or deferred income, depending on the specific facts and circumstances of the transaction. Any one of the following factors independently creates a rebuttable presumption that classification of the proceeds as debt is appropriate:

- The transaction does not purport to be a sale (that is, the form of the transaction is debt).

- The entity has significant continuing involvement in the generation of the cash flows due the investor (e.g., active involvement in the generation of the operating revenues of a product line, subsidiary, or business segment.)
- The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
- The investor's rate of return is implicitly or explicitly limited by the terms of the transaction.
- Variations in the entity's revenue or income underlying the transaction have only a trifling effect on the investor's rate of return.
- The investor has any recourse to the entity related to the payments due the investor.

3.042 Amounts Classified as Deferred Income. The classification of the proceeds from a sale of future foreign currency revenues as deferred income results in a nonmonetary liability that is not subject to foreign currency transaction gains or losses under ASC Topic 830. In other words, an entity would record the cash received from the investor as deferred revenue at the functional currency equivalent on the date of sale and this amount would become the historical basis of the deferred revenue account. The entity would amortize the deferred revenue under the units-of-revenue method. Under the units-of-revenue method, amortization for a period is calculated by computing a ratio of the proceeds received from the investor to the total payments expected to be made to the investor over the term of the agreement, and then applying that ratio to the period's cash payment.

3.043 A portion of the deferred revenue may be refundable if the entity fails to carry out its future obligations. The existence of a refund provision would not cause the deferred revenue balance to be a monetary item because there is a presumption that the entity will carry out its obligations as part of its normal business practices. However, if the entity no longer plans to fulfill its obligation and intends to deliver a monetary item as a refund, the corresponding deferred revenue would be a monetary item.

3.044 Amounts Classified as Debt. The classification of proceeds from a sale of future revenues as foreign currency-denominated debt results in a monetary liability subject to recognition of foreign currency transaction gains and losses under ASC Topic 830. The entity would amortize the debt under the interest method. The currency denomination of the debt would be based on the denomination of the future revenue sold.

FOREIGN DEBT-FOR-EQUITY SWAPS

3.045 ASC paragraphs 830-20-55-1 through 55-3 address the accounting for a transaction in which a U.S. entity purchases, at less than face value, some dollar-denominated debt due from a foreign government or an entity that operates in that foreign country. Simultaneously, the U.S. entity exchanges the debt with the foreign government in a transaction denominated in the foreign currency. The foreign government requires the

U.S. entity to invest the foreign currency proceeds in the U.S. entity's subsidiary operating in that foreign country. The issue is how the U.S. entity should report the difference, if any, between the U.S. dollar values of those two transactions.

3.046 The example transaction discussed by ASC paragraphs 830-20-55-1 through 55-3 is presented below.

Example 3.8: Foreign Debt-for-Equity Swap

A U.S. company with operations in Mexico (through a Mexican subsidiary) purchases a U.S. dollar-denominated loan from a financial institution for \$5 million (the loan's secondary market value). The loan's principal is \$10 million, and is owed by a Mexican entity. The Mexican government purchases the loan from the company for Mexican pesos worth U.S. \$8.5 million (at current currency exchange rates). The company is required to remit the pesos obtained from sale of the loan to its Mexican subsidiary, and the subsidiary issues capital stock to the company. An agreement with the Mexican government restricts redemption of the stock, dividend payments on the stock, and sales of the stock in Mexico for a stated period of time. All of these provisions are designed to retain the pesos in the Mexican economy. Also, the agreement requires the pesos to be used for a specified purpose in the Mexican subsidiary (such as to make a capital expenditure). A U.S. \$3.5 million credit arises in the company's consolidated financial statements because its Mexican subsidiary's net assets increased \$8.5 million while the company *invested* only \$5 million to achieve such an increase.

3.047 ASC paragraphs 830-20-55-1 through 55-3 indicate that the excess of the local currency proceeds translated at the official currency exchange rate over the purchase price of the loan (the *excess*) should be used to reduce the basis of the long-lived assets acquired or constructed to comply with the arrangement. If the arrangement does not require the acquisition or construction of long-lived assets, or if the excess exceeds the cost of the assets, the excess should be applied to reduce the carrying amount of existing long-lived assets, other than goodwill, as follows:

- First, to reduce the basis of the fixed asset with the longest remaining useful life until it is reduced to zero;
- Next, to reduce the basis of other fixed assets starting with the one with the next longest remaining useful life; and
- Once all fixed assets are reduced to zero, any remaining excess should be reported as a bargain purchase as required by ASC Subtopic 805-10, *Business Combinations - Overall*

3.048 As stated in ASC paragraph 830-20-55-3, the guidance in Paragraph 3.047 applies also to a debt-for-equity swap with both of the following characteristics (resulting in the excess being reported as a bargain purchase as required by ASC Subtopic 805-10):

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

ADVANCES TO SUPPLIERS/PREPAID EXPENSES, ACCOUNT RECEIVABLES, CONTRACT ASSETS, CONTRACT LIABILITIES, REFUND LIABILITIES

3.049 This section relates to performance of contract obligations either before or after receiving payment from the other party.

	Type	In scope of 606	Monetary / nonmonetary	Section
Advance to suppliers /prepaid expense	Asset	No	Monetary or nonmonetary	3.049a
Accounts receivable	Asset	Yes	Monetary	3.050
Contract asset	Asset	Yes	Generally monetary	3.050
Contract liability	Liability	Yes	Nonmonetary	3.050
Refund liability	Liability	Yes	Monetary	3.050a

ADVANCES TO SUPPLIERS AND PREPAID EXPENSES

3.049a The accounting for foreign currency-related advances and prepayments for goods and services depends on the nature of the advances. ASC paragraph 255-10-55-1 indicates that if the ultimate purchase price of the goods or services fluctuates with market prices, the advance payment or deposit does not represent a claim to a given quantity of goods or services; instead, it is a right to receive credit for a sum of money. In this instance, the entity treats the advance payment or deposit as a monetary asset in the remeasurement process.

However, if the advance payment is for the purchase of goods or services at a fixed price, and the advance is not refundable, the advance payment is more in the nature of a claim to future delivery of goods or services. In this instance, an entity treats such an advance payment as a nonmonetary asset in the remeasurement process (i.e., measured and recorded in the functional currency at the historical exchange rate). ASC paragraph 255-10-55-1

Example 3.9: Advances to Suppliers

ABC Corp. has a subsidiary that is a shrimp producer located in a highly inflationary country. Because this subsidiary is located in a highly inflationary economy, it must

remeasure its financial statements as if its functional currency were ABC's reporting currency, the U.S. dollar. The subsidiary advances funds in local currency to various unrelated vendors to partially cover the farmers' cost of shrimp larvae and operating expenses. After the shrimp are harvested, the subsidiary purchases the shrimp from the farmers by paying the difference between the current market price for shrimp and the advance payment.

In this example, the advance payments made by ABC should be remeasured at the current exchange rate, and a transaction gain or loss should be recognized in net income. Because the ultimate purchase price for the inventory depends on future market prices, the advance payments in substance are loans with a right to offset against future payables, and thus are monetary assets subject to future foreign currency fluctuation.

ACCOUNTS RECEIVABLE, CONTRACT ASSETS, CONTRACT LIABILITIES AND REFUND LIABILITIES

3.050 Assets and liabilities that result from revenue transactions in the scope of ASC Topic 606 may include contract assets, trade receivables, contract liabilities (deferred revenue) and refund liabilities. Typically, the trigger for recognizing a contract asset, a contract liability, a refund liability and/or a receivable on the balance sheet is performance by one of the parties to the contract. The following table includes a description of each of these balance sheet terms and whether they are treated as monetary or nonmonetary in the remeasurement process.

Term	Description	Monetary or nonmonetary
Receivable	Unconditional rights to consideration. A right to consideration is unconditional if payment is due or if only the passage of time is required before payment becomes due.	Monetary because it represents a fixed or determinable amount without reference to future prices of specific goods or services that will be settled in cash by the customer.
Contract asset	When an entity has provided goods or services under a contract with a customer prior to it having the unconditional right to bill the customer, the amount due from the customer is recorded as a contract asset (some entities may describe this as costs in excess of billings).	Similar to receivables, generally monetary assets as they will generally be settled in cash from the customer
Contract liability	When an entity receives an advance payment for the	Nonmonetary liability (i.e., measured and recorded in the

(deferred revenue)	purchase of goods or services at a fixed price and such advance is not refundable, the resulting liability from the advance payment represents an obligation to deliver goods or services.	functional currency at the historical exchange rate) because it represents an obligation to deliver goods or services.
Refund liability	The amount of consideration received from a customer to which an entity does not expect to be entitled (the amount that will be refunded).	Generally, monetary because it represents an obligation to refund cash to the customer.

3.050a Refund liability. ASC paragraph 606-10-32-10 requires an entity to recognize a refund liability if it receives consideration from a customer and expects to refund some or all of that consideration to the customer (e.g., rights to return). A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (i.e., amounts not included in the transaction price). While a refund liability is generally not a contract liability, an entity should consider the specific facts and circumstances of the arrangement to determine whether a refund liability is a contract liability. See Question 14.4.10 of KPMG Handbook, [Revenue recognition](#), for additional information. As discussed in Paragraph 3.050, contract liabilities are nonmonetary liabilities, which are measured and recorded in the functional currency at the historical exchange rates. A refund liability that is not considered a contract liability is a monetary item.

INVENTORIES

3.051 Applying Lower of Cost or Net Realizable Value/Market Test. The guidance on subsequent measurement of inventory in ASC Section 330-10-35 requires special application when an entity's functional currency is not the local currency and the entity does not maintain the books of record in the functional currency. The first step is to remeasure inventory carried at cost in local currency to historical cost in the functional currency (i.e., remeasure using historical exchange rates). Then, inventory as stated at cost in the functional currency is evaluated for impairment under the subsequent measurement guidance using the functional currency. Application of the subsequent measurement guidance might require a write-down of inventory in the functional currency statements, even though a write-down would not be required in the local currency. Likewise, a write-down of inventory recognized in local currency may need to be reversed if the application of the subsequent measurement guidance in the functional currency does not require one. Once inventory is written down in the functional currency financial statements, that functional currency amount should continue to be the carrying amount until the inventory is sold or a further write-down is necessary (i.e., the write-down should not be reversed until the inventory is sold). An asset other than inventory

may sometimes be written down from historical cost. Although different measurement guidance may be used to determine the write-down for an asset other than inventory, 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 local currency, and a write-down in the local currency may need to be reversed before remeasurement to prevent the remeasured amount from exceeding functional currency historical cost. ASC paragraph 830-10-55-8

3.052 ASC Topic 830 points out that an inventory write-down in the functional currency may occur when the local currency declines in relation to the functional currency between the date the inventory was acquired and the balance sheet date. However, such a write down may not be necessary. For example, a write down may not be necessary for inventory measured using the first-in, first-out methodology if the net realizable value expressed in the local currency has increased sufficiently so that net realizable value exceeds its historical cost measured in the functional currency. ASC paragraph 830-10-55-9

Example 3.10: Application of Lower of Cost or Market Test in Remeasurement

A U.S. corporation's foreign subsidiary, whose functional currency is the U.S. dollar, purchases inventory for LC500 when the exchange rate is LC1 = US\$2.40. The inventory is measured using the last-in, first-out method. At the balance sheet date, the replacement cost of the inventory is LC600, the net realizable value is LC700, the net realizable value less normal profit margin is LC550, and the exchange rate is LC1 = US\$1.80.

The historical cost of inventory in the functional currency of the U.S. dollar is \$1,200 ($LC500 \times 2.40$) and market, which in this case equals replacement cost of the inventory, which based on ASC Section 330-10-35, is \$1,080 ($LC600 \times 1.80$). Accordingly, a lower of cost or market write-down of \$120 ($\$1,200 - \$1,080$) is required and the foreign subsidiary will carry the inventory at \$1,080 in its functional currency financial statements.

If, however, the net realizable value would be LC800 and the net realizable value less normal profit margin would be LC700, then market would equal net realizable value less normal profit margin, based on ASC Section 330-10-35, which would be \$1,260 ($LC700 \times 1.80$). In that scenario, no write-down would be required.

Q&A 3.3: Calculation of Replacement Cost

Q. A foreign entity's books of record are remeasured into the functional currency. The foreign entity measures inventory using the last-in, first-out method. To calculate replacement cost (market value) of finished goods inventory for the lower of cost or

market test, should the depreciation component of overhead be provided at historical exchange rates or at current exchange rates?

A. According to ASC paragraph 830-10-45-18, depreciation should be remeasured using historical rates. That remeasured depreciation should be used to calculate replacement cost for the lower of cost or market test.

IMPAIRMENT IN FUNCTIONAL CURRENCY-EQUIVALENT VALUES OF LONG-LIVED ASSETS

3.053 Evaluating whether the carrying value of a long-lived asset is impaired in accordance with ASC Subtopic 360-10, *Property, Plant, and Equipment - Overall*, requires special application when the entity's functional currency is not the local currency and the books of record are not maintained in the functional currency. The entity should perform the impairment evaluation using its functional currency. This could result in a functional currency impairment or a reversal of local currency impairments as described in Paragraphs 3.051-3.052.

Example 3.11: Impairment Testing of a Long-Lived Asset

A U.S. company's foreign subsidiary, whose functional currency also is the U.S. dollar, previously purchased a building for its primary use using the local currency. As provided in ASC paragraphs 830-10-45-17 and 45-18, the purchase of the building in the local currency was converted into the U.S. dollar functional currency at the date of purchase and continues to be remeasured using this historical currency exchange rate. Assume that the building is evaluated as a single asset under the grouping provisions of ASC Subtopic 360-10. As a result of significant operating losses in the current period, the subsidiary evaluates the building for impairment. The subsidiary prepares an analysis of the undiscounted cash flows expected to result from the use and eventual disposition of the building in the local currency that indicates the carrying value is recoverable. However, as a result of a devaluation of the local currency, the U.S. dollar value equivalent of the sum of the undiscounted cash flows indicates that the carrying value of the building in U.S. dollars is not recoverable. The U.S. company's foreign subsidiary should recognize an impairment loss for the amount by which its carrying value (remeasured using the historical currency exchange rate) of the building exceeds its U.S. dollar-equivalent fair value.

SHARE-BASED PAYMENTS

3.054 Share-based payments issued by multinational companies to employees around the world sometimes give rise to foreign currency considerations. This section divides those considerations into classification of awards as either liabilities or equity, measurement of awards, and recognition of compensation costs.

3.055 Classification of Awards as Either Liabilities or Equity. Under ASC Topic 718, *Compensation--Stock Compensation*, share-based payment awards are classified as either liabilities or equity. The classification of an award affects the measurement date(s) of the award, and the timing and amount of compensation costs recognized by the entity.

3.056 An award that is payable to employees of a foreign operation and denominated either in the functional currency of that entity or in the currency that is used for payroll purposes (i.e., it matches one of the two currencies) will be equity-classified if it otherwise meets the requirements for equity classification. ASC paragraph 718-10-25-14, Statement 123(R), pars. 33, fn 19, B129, EITF 00-23, Issue No. 31

3.057 In addition, an award with an exercise price denominated in the currency of a market in which a substantial portion (which could be less than the majority) of the entity's equity securities trades is not considered to contain a condition that is not a market, performance, or service condition. Therefore, the share-based payment award is not liability-classified if it otherwise qualifies for equity classification. For example, a parent entity whose functional and payroll currency is the Canadian dollar grants share options with an exercise price denominated in the U.S. dollar to Canadian employees. If a substantial portion of the parent entity's equity securities trades on a U.S. dollar-denominated exchange, the options are not precluded from being equity-classified. ASC paragraph 718-10-25-14A

3.058 Measurement of Awards. The frequency of measurement of an award depends on its classification as either a liability or equity. Liability-classified awards are remeasured to fair value each reporting period until the award is settled. Equity-classified awards are measured on the grant date and are not subsequently changed. Awards with an observable market price (e.g., a grant of nonvested shares) are valued at that price. Otherwise, the awards are valued using a valuation model.

3.059 If the exercise price of the share-based awards (e.g., stock options) is denominated in the same currency in which the stock price is quoted, then the fair value of the options should be measured in that currency using a standard option-pricing model.

3.060 If the exercise price is denominated in a currency that is different from the currency in which the stock price is quoted, then a modified option-pricing model should be used to estimate the fair value of the options. In addition to the usual input variables, the modified option-pricing model would require the current exchange rate, the volatility of the exchange rate, the correlation of the exchange rate and the stock price, and risk-free interest rates in both currencies.

3.061 If the fair value of the options is measured in a currency other than the grantor's functional currency, the fair value at the measurement date(s) should include a remeasurement using a spot exchange rate. For example, if a Canadian company with CAD as its functional currency has shares that trade on an exchange listed in the United States and issues share-based payments (e.g., stock options) denominated in USD, after estimating the USD fair value of the share-based payments, the company would

remeasure the fair value of the awards to CAD at the spot rate on the measurement date(s).

3.062 Recognition of Compensation Cost. For liability-classified awards, before vesting, cumulative compensation cost equals the proportionate amount of the award earned to date (after vesting, the entire change in fair value is recorded in net income). For equity-classified awards, the grant-date fair value is recognized in net income over the requisite service period and is not subsequently remeasured.

3.063 If an entity, such as a parent company, grants share-based awards (e.g., stock options) to employees of a foreign subsidiary with a different functional currency from the grantor's, the subsidiary in its separate stand-alone financial statements would recognize its allocated portion of the grantor's compensation cost in its functional currency using the weighted average exchange rate for the reporting period. The awards would be classified in the subsidiary's financial statements as equity or as a liability in the same manner as in the parent's consolidated financial statements.

3.064 Upon exercise of the share-based payments (e.g., stock options), the employer should measure the proceeds at the then-current exchange rate, and the difference is recorded in stockholders' equity. Because there are no monetary assets or liabilities to be remeasured, there is no foreign currency transaction gain or loss arising from issuing or exercising the stock options.

DIVIDENDS

3.065 Foreign Currency-Denominated Dividends. When an entity declares a dividend payable denominated in a foreign currency, an issue may arise as to whether the change in exchange rates from the declaration date to the date of payment should be recognized in net income as a transaction gain or loss or through retained earnings on the basis that it relates to a capital transaction. A dividend payable recognized at the declaration date is a monetary liability. This conclusion is not affected by what event generated such payable. Accordingly, the transaction gain or loss on the foreign currency-denominated dividend payable should be recognized in net income.

REDEEMABLE PREFERRED STOCK

3.066 Preferred stock in general, including preferred stock that is redeemable at the option of the issuer, is considered a nonmonetary item and is remeasured at its historical exchange rate like other components of equity. However, certain preferred stock, such as mandatorily redeemable stock subject to ASC Topic 480, *Distinguishing Liabilities from Equity*, is classified as debt. Preferred stock classified as debt is a monetary item subject to remeasurement at current exchange rates. An entity would recognize any remeasurement gains or losses in net income as foreign currency transaction gains or losses. Further, if the entity classifies redeemable preferred stock as debt, it would present dividend payments from such instruments as interest expense.

3.067 Certain preferred stock may be contingently redeemable, such as when redemption is triggered by a change in control of the issuer, or redeemable at the option of the holder. These redeemable preferred securities are presented as temporary equity separate from permanent equity by SEC registrants under paragraph 480-10-S99-3A (formerly EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities*). Similar to other equity instruments, equity instruments presented as temporary equity are considered nonmonetary components of equity that do not give rise to remeasurement gains or losses under Topic 830. However, they are subject to EITF D-98 measurement requirements and the effects of foreign currency redemption features should be considered in determining redemption value under EITF D-98.

3.068 Specifically, if a redemption feature subject to EITF D-98 is denominated in a currency other than the functional currency of the issuer, we believe measurement of redemption value must incorporate the effect of exchange rates on the functional currency amount of the redemption feature. Depending on the nature of the redemption feature, EITF D-98 may or may not require current remeasurement on the balance sheet. For instance, a contingent redemption feature does not result in remeasurement unless the contingency is probable of occurring such that the instrument is likely to become redeemable at a future date. However, to the extent EITF D-98 requires current period remeasurement, we believe foreign currency exchange rates should be considered in that measurement and their effect would either increase or reduce the effect of EITF D-98 deemed dividends on income available to common shareholders and reported earnings per share. As prescribed by EITF D-98, that effect should never reduce the carrying value of the equity instrument below its initial fair value. EITF Issue D-98

3.069 While classification of redeemable stock discussed above outside of permanent equity is required for SEC registrants, we believe it is preferable for nonregistrants to follow an accounting policy consistent with SEC guidance as well (i.e., an EITF D-98 accounting policy). Alternatively, private companies that do not follow EITF D-98 would classify the preferred stock within permanent equity. However, to highlight the preferential distributions required for such instruments, we believe nonregistrants should generally apply measurement guidance consistent with the principles contained in EITF D-98 even if instruments otherwise subject to EITF D-98 are classified within permanent equity on the entity's balance sheet.

3.070 When an entity's reporting currency is different from the functional currency applicable to an instrument classified as temporary equity under EITF D-98, a question arises as to whether the entity should adjust the amount presented for temporary equity to the current reporting currency value of the obligation. We believe that consistent with the basic principles contained in EITF D-98 and ASC Topic 830, it would be appropriate to translate amounts classified as temporary equity using the historical exchange rate as of the most recent EITF D-98 remeasurement. This is because each EITF D-98 remeasurement is essentially treated as a repurchase within equity whereby the previous equity value is replaced by an updated equity value with any difference presented as a deemed dividend. Consistent with the treatment of new issuances or repurchases of equity, as each remeasurement occurs we believe a new historical exchange rate for the entire equity instrument should be established for translation purposes, which also

ensures the translated amount reported to investors represents the most recent reporting currency value as of the last EITF D-98 remeasurement. An instrument that is redeemable currently will be remeasured under EITF D-98 each period and translated based on current exchange rates. In contrast, an instrument presented as temporary equity but for which redemption is not probable will be translated based on the historical exchange rate in effect when the instrument was last measured, which would likely have been its issuance date.

DUAL CURRENCY BONDS

3.071 Dual currency bonds provide for repayment of principal in the functional currency and periodic fixed-rate interest payments denominated in a foreign currency. The basic form of the dual currency bond is noncallable and the interest payments are nondetachable. ASC Topic 830 applies to these debt instruments and requires the present value of the interest payments denominated in a foreign currency to be remeasured and the foreign currency transaction gain or loss recognized in net income. As required by ASC paragraphs 815-15-55-209 and 55-210, the foreign currency-denominated liability for the future interest payments is remeasured by (i) translating the future foreign currency interest payments into the functional currency using the spot currency exchange rate at the reporting date, and (ii) discounting the resulting future functional currency interest payments at the historical effective interest rate. ASC paragraphs 815-15-55-209 and 55-210 also state that a dual currency bond should not be considered to contain an embedded foreign currency derivative instrument pursuant to ASC paragraph 815-15-15-10.

Example 3.12: Dual Currency Bonds

ABC Corp., a U.S. entity, issues US\$100,000 of dual currency bonds having a three-year term and requiring annual foreign currency (FC) interest payments of FC10,000. The currency exchange rate is US\$1.00 = FC1.40 at the date of issue. The effective interest rate of the dual currency bonds, using the spot currency exchange rate at inception to determine the future functional currency interest payments, is 7.14%. Using this discount rate, the bonds can be analyzed as follows:

		US\$
Present value of:		
Interest payments	Year 1	6,667
	Year 2	6,222
	Year 3	<u>5,807</u>
		18,696
Principal payment		<u>81,304</u>
		100,000

Note: The present value of the Year 1 payments, for example, is calculated as follows:
 $[\text{FC}10,000 \div \text{FC}1.40/\$] \div 1.0714$.

The dual currency bond consists of the present value of the principal payment denominated in U.S. dollars and the present value of the interest payments denominated in FC. The discount on the principal component is equal to the present value of the FC-denominated interest component measured in U.S. dollars. ABC will accrete the discount on the principal component as interest expense. Because this expense and the principal of the dual currency bond are denominated in U.S. dollars, there is no foreign currency effect.

Under Statement 52, the interest component of the dual currency bonds at the date of issue represents a foreign currency-denominated liability of FC26,175 ($[\text{FC}10,000 \div 1.0714] + [\text{FC}10,000 \div 1.07142] + [\text{FC}10,000 \div 1.07143]$). The effects of changes in the FC/US\$ currency exchange rate on this component of the dual currency bonds are recognized in net income as foreign currency transaction gains or losses.

For example, assume that during Year 1 the average currency exchange rate is US\$1 = FC1.5 and at the end of Year 1 the currency exchange rate is US\$1.00 = FC1.60. ABC would roll forward the interest component of its dual currency bonds as follows:

	FC	FC/US\$	US\$
Beginning of Year 1:			
Issuance	26,175	1.4	18,696
During Year 1:			
Interest accretion	1,869	1.5	1,246
End of Year 1:			
Interest payment	(10,000)	1.6	(6,250)
Transaction gain			<u>(2,414)</u>
Balance	<u>18,044</u>	1.6	<u>11,278</u>

During Year 1 ABC accrues interest expense of 7.14% on the interest component of FC 26,175, translated at the average exchange rate into US\$1,246, and also recognizes as interest expense the accretion of US\$5,807 on the net present value of the principal component of US\$81,304. At the end of Year 1 ABC recognizes the interest payment of US\$6,250, and remeasures the interest component of the liability of FC18,044

$([FC10,000 \div 1.0714] + [FC10,000 \div 1.07142])$ at the current exchange rate, which results in a transaction gain of US\$2,414.

UNAMORTIZED DEBT DISCOUNTS, PREMIUMS AND ISSUANCE COSTS

3.071a Unamortized debt discounts, premiums and issuance costs. Unamortized debt discounts and issuance costs related to a recognized debt liability are deducted from the debt liability while unamortized debt premiums are added to the debt liability. ASC paragraph 255-10-55-1 lists unamortized debt discounts and premiums that are inseparable from the debt to which they relate as monetary items. We believe that debt issuance costs are also monetary items, similar to unamortized debt discounts and premiums. Therefore, these items are remeasured each period using current exchange rates and a corresponding foreign currency transaction gain (loss) is recognized in earnings.

EXCHANGE OR MODIFICATION OF DEBT

3.072 Debtor's Accounting for a Modification or Exchange of Foreign Currency-Denominated Debt Instruments. ASC Subtopic 470-50, *Debt - Modifications and Extinguishments*, provides guidance for determining when an exchange of debt instruments between, or a modification of a debt instrument by, a debtor and a creditor should be accounted for as a debt extinguishment. ASC paragraph 470-50-40-6 states that an exchange of debt instruments with substantially different terms is a debt extinguishment and should be accounted for in accordance with ASC paragraph 405-20-40-1 and a substantial modification of terms of a debt instrument should be accounted for like, and reported in the same manner as, an extinguishment.

3.073 ASC paragraph 470-50-40-10 provides that from the debtor's perspective, an exchange of debt instruments between, or a modification of a debt instrument by, a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original instrument (the *10 percent test*). An issue may arise as to the application of the 10 percent test when the debt instrument is denominated in a different currency after the modification or exchange. When evaluating whether a modification or exchange of debt instruments denominated in different currencies is substantial, entities make one of the following accounting policy elections: (a) use the currency exchange rate in effect at the date of the modification or exchange or (b) use an appropriate forward currency exchange rate to determine the cash flows in the 10% test under paragraph 470-50-40-10. The discount rate used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt. We also believe it would be acceptable to make an accounting policy election that assumes any change in the currency in which the debt is denominated is always a substantial modification of the debt, and, thus, should be accounted for like, and

reported in the same manner as, an extinguishment. The issuer should consistently apply the accounting policies it adopts.

3.074 In calculating the present value of the cash flows of the original debt instrument and the new or modified debt instrument when the currency denomination of the debt has not changed, we believe the currency exchange rate in effect at the date of the exchange or modification should be used to calculate the present value of the cash flows of the foreign currency-denominated debt instrument. Thus, the fact that the debt instrument is denominated in a foreign currency will have no effect on the results of the 10 percent test.

3.075 Debtor's Accounting for Changes in Foreign Currency-Denominated Line-of-Credit or Revolving-Debt Arrangements. ASC paragraphs 470-50-40-21 and 40-22 address the accounting for modifications to or exchanges of line-of-credit or revolving-debt arrangements resulting in either a new line-of-credit or revolving-debt arrangement or resulting in a traditional term-debt arrangement. ASC paragraph 470-50-40-21 indicates that the debtor should compare the borrowing capacity of the original arrangement to that of the new arrangement at the time of the change. An issue may arise about the appropriate currency exchange rate to use to calculate the borrowing capacity when the modification or exchange results in a change in the currency in which the line-of-credit or revolving-debt arrangement is denominated, or when the arrangements are denominated in a foreign currency. We believe that in either situation the current rate of the foreign currencies should be used to measure and compare the borrowing capacities on a functional currency-equivalent basis.

LEASES

3.076 Not used.

3.076a Foreign Currency-Denominated Leases – After Adoption of ASU 2016-02. Upon adopting ASU 2016-02, Leases (Topic 842) a lessee recognizes a lease liability and a right-of-use asset for all leases (including operating leases) with a term greater than 12 months, which significantly increases reported assets and liabilities for some lessees.

3.076b Regardless of lease classification as finance or operating, the right-of-use asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, for a lease denominated in a foreign currency, remeasurement into the lessee's functional currency is required using the following rates.

- Lease liability: the current exchange rate at the reporting date.
- Right-of-use asset: the historical exchange rate used at the later of initial measurement (i.e., the commencement date) or the most recent remeasurement for which a reset of the exchange rate is required or lease modification not accounted for as a separate contract. ASC paragraphs 842-20-55-10 and 830-10-45-17 to 45-18.

See section 6.4.3 of KPMG Handbook, [Leases](#), for additional questions and examples associated with the impact of foreign currency on leases.

DEFERRED TAXES

3.077 Reporting Transaction Gains and Losses Related to Foreign Deferred Tax Assets and Liabilities. Under ASC Section 830-20-45 and ASC Section 830-740-45, *Foreign Currency Matters – Income Taxes*, deferred income tax assets and liabilities are monetary items and, thus, should be remeasured at current currency exchange rates. Transaction gains and losses resulting from remeasurement of a foreign deferred tax asset or liability may be included in deferred tax expense (benefit), if that presentation is considered more useful, or reported separately. Section 7. Foreign Operations, of KPMG Handbook, [Accounting for Income Taxes](#), provides guidance on accounting for income taxes. ASC paragraphs 830-20-45-3, 830-740-45-1

3.078 ASC paragraph 830-20-45-1 requires presentation in the financial statements or disclosure in the notes of the aggregate transaction gain or loss included in the determination of net income for the period. The transaction gain or loss related to deferred taxes should be included in the aggregate transaction gain or loss that is required to be disclosed, whether the transaction gain or loss is included in deferred tax expense (benefit) or reported separately in the income statement.

OTHER LIABILITIES

3.079 Advances from Customers. Advance payments received from customers for the purchase of goods or services represent either contract liabilities or refund liabilities. See section 3.050 and 3.050a for discussion of contract liabilities and refund liabilities, respectively.

3.080 Foreign Currency-Denominated Reinsurance Premiums. A reinsurance company may write foreign currency-denominated reinsurance. Foreign currency-denominated short-duration contract premiums collected during a period are recorded in an unearned premium account and recognized ratably over the contract period. At each reporting date, it is necessary to consider whether sufficient premiums have been collected to meet the projected foreign currency-denominated claims for the remainder of the insurance contract period. To the extent that premiums are insufficient, a premium deficiency reserve is established at the reporting date.

3.081 The unearned premium account is a nonmonetary liability because it principally represents an obligation to provide insurance coverage. (ASC paragraph 255-10-55-1) A premium deficiency analysis should be performed initially at the foreign currency level. Any deficiency existing at that level should be recorded as an underwriting loss. If an additional premium deficiency emerges upon remeasurement into the functional currency, it should be recorded as a loss on a foreign currency transaction.

Example 3.13: Premium Deficiency Analysis

ABC Corp. (a reinsurance company whose functional currency is the US\$) has foreign currency (FC) denominated unearned premiums of FC100. The estimated sum of expected claim costs, claim adjustment expenses, maintenance costs, etc., is FC80, and there are no deferred acquisition costs before remeasurement into the functional currency. Accordingly, in local currency, no premium deficiency exists. If one did exist, ABC would reflect it in underwriting results before remeasurement into the functional currency. The historical and current exchange rates are FC4/US\$1 and FC2/US\$1, respectively. The unearned premiums would be US\$25 (remeasurement at historical rates). The expected claim costs, expenses, etc., however, would total US\$40 remeasured at current rates. ABC should use the current currency exchange rate for remeasurement because it is the best estimate of the future currency exchange rate at which it will incur the claims, expenses, etc. Accordingly, a premium deficiency of US\$15 exists at the functional currency level. ABC should present this premium deficiency as a loss on a foreign currency transaction instead of an underwriting loss.

3.082 Warranty Obligations. An entity may provide a warranty for a product sold or service provided in a foreign currency to a customer (e.g., to guarantee that a product will function as stated in the published specifications), which may be fulfilled by different means. In certain instances, the warranty obligation may be satisfied by the entity (e.g., the entity receives a defective product and repairs the defect(s) to return the product to its original condition or replaces the defective product with a new product), which would represent a nonmonetary liability that would not be subject to remeasurement under ASC Topic 830. In other instances, an entity may contract another party to satisfy its performance obligation and make payment to the other party in a currency that is not the entity's functional currency. For example, an entity that is USD functional, may contract a warranty repair party in Canada to make repairs and satisfy future warranty obligations, which would be payable in CAD. In this instance, we believe the warranty obligation would be considered a monetary liability and would be subject to remeasurement.

3.083 Not used.

3.084 Foreign Currency Transactions by Investment Companies. ASC Subtopic 946-830, *Financial Services--Investment Companies--Foreign Currency Matters*, provides guidance on the measurement and financial statement presentation and disclosure of foreign currency transactions by investment companies. For foreign currency transactions, ASC Section 946-830-45 requires separate identification, computation, and reporting of the changes in fair value due to changes in currency exchange rates and changes in market prices, other than for gains and losses on investments. Paragraph 2.160 of the AICPA Audit and Accounting Guide, *Investment Companies*, and ASC paragraph 946-830-45-4 state that the practice of not disclosing separately the portion of the changes in fair value of investments and realized gains and losses thereon that result from foreign currency rate changes is permitted. For companies that adopt separate reporting,

Appendix F to the above guide provides illustrations of separately calculating and disclosing the foreign currency element of realized and unrealized gains and losses.

3.085 Financial Liabilities for which the Fair Value Option Is Elected. An entity may elect the fair value option for a financial liability. The change in fair value, expressed in functional currency terms, of a financial liability denominated in a currency other than the entity's functional currency includes the change in fair value attributable to changes in currency exchange rates and changes in fair value attributable to other factors. Changes in fair value attributable to changes in currency exchange rates are split between:

- the instrument-specific credit risk component (recognized in other comprehensive income); and
- the remaining changes in fair value (recognized in net income).

See section 6 of KPMG Handbook, [Investments](#), for additional guidance on these liabilities.

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GENERAL PRINCIPLES

4.000 Under ASC Topic 830, *Foreign Currency Matters*, separate entities within an enterprise that operate in different economic and currency environments may prepare financial statements in their respective functional currencies. For consolidation purposes, the functional currency financial statements of all entities that are consolidated or accounted for by the equity method within an enterprise must be translated into a single unit of measure (i.e., the reporting currency of the reporting enterprise). The objective of this process is to reflect in consolidated financial statements:

- The economic effects on an enterprise's cash flows and equity of a change in exchange rates; and
- The financial results and relationships of the individual consolidated and equity method entities as measured in their functional currencies. ASC paragraph 830-10-10-2

4.001 The FASB concluded that translating foreign currency financial statements using current exchange rates best meets the above objective. Statement 52, pars. 95, 98

4.002 Translation adjustments resulting from changes in exchange rates do not affect reporting currency cash flows until the respective foreign entity is sold, exchanged, or liquidated. Those adjustments can be viewed as unrealized gains or losses, therefore, they are not reported as part of the results of operations, but rather in other comprehensive income until realized on sale, exchange, or liquidation of the foreign entity. See Paragraphs 4.036 through 4.054 for additional guidance on the accounting for translation adjustments upon the sale, exchange, or liquidation of an investment in a foreign entity and Paragraphs 2.001 through 2.003a for additional guidance on the definition of a foreign entity. ASC paragraph 830-30-45-12, Statement 52, pars. 110-114

4.003 Sometimes an entity's books of record may not be maintained and its financial statements initially may not be prepared in its functional currency (e.g., if its functional currency is not the local currency of the entity's country of residence). Remeasurement of those financial statements into the entity's functional currency technically does not represent a translation of foreign currency financial statements as that term is used in ASC Topic 830, although the remeasurement may be done as part of the consolidation process. That remeasurement is discussed beginning in Paragraph 4.055.

ELECTION OF EXCHANGE RATES

4.004 Translation of Foreign Currency Financial Statements Using Current Exchange Rates. An entity must translate all elements of financial statements into the reporting currency of the reporting enterprise using the current exchange rate. The current exchange rate is the rate at which one unit of a currency can be exchanged for (converted into) another currency. For assets and liabilities, that exchange rate is the rate at the balance sheet date. For revenues, expenses, gains, and losses, the enterprise uses the exchange rate at the dates on which those elements were recognized. For equity accounts,

the appropriate rate is the historical exchange rate. ASC paragraph 830-30-45-3, ASC Section 830-30-20

4.005 Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized generally is impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. 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 or month's average rate. This averaging process also applies to accounting allocations such as depreciation, cost of sales, and amortization. Those items are translated at the current exchange rate on the dates they are included in the income statement, not the rates on the dates the related balance sheet items originated. However, if significant nonrecurring items related to a specific event are recognized (e.g., a gain on the sale of a subsidiary), it may be more appropriate to use the rate at the date the event occurred. Retained earnings represent accumulated net income, therefore, it is translated at the weighted average of the historical rates in effect when the income was earned or distributed. ASC paragraphs 830-10-55-10 and 55-11, 830-30-45-3

4.006 If a foreign entity whose balance sheet date is different from that of the reporting enterprise is consolidated or combined with or accounted for by the equity method in the financial statements of the reporting enterprise, the exchange rate in effect at the foreign entity's balance sheet date and an appropriately weighted average exchange rate for the foreign entity's fiscal period should be used for translation. The enterprise should not adjust for rate changes after the foreign entity's balance sheet date. However, it should disclose significant effects of rate changes after the balance sheet date on unsettled balances of foreign currency transactions. ASC paragraphs 830-30-45-8, 830-30-45-16

4.007 Determining the current exchange rate is a question of fact. ASC paragraph 830-30-45-6[US_FASB_ASC_830_030_45_6] states that, in the absence of unusual circumstances, the rate applicable to conversion of a currency for purposes of dividend remittances should be used to translate foreign currency financial statements. That rate is more meaningful than any other rate because cash flows to the reporting enterprise from the foreign entity can be converted at only that rate, and realization of a net investment in a foreign entity ultimately will be in the form of cash flows from the entity. Unusual circumstances that could affect the current exchange rate are discussed in Paragraphs 4.008-4.012.

4.008 Temporary Lack of Exchangeability. ASC paragraphs 830-20-30-2 and 830-30-45-9 state that if exchangeability between two currencies is temporarily lacking at the transaction or balance sheet date, the rate that should be used is the first subsequent rate at which exchanges could be made. The FASB staff illustrated this concept in ASC paragraph 830-30-55-1. ASC paragraph 830-30-55-1 is discussed further in Paragraph 3.014 of this guide.

Q&A 4.1: Currency Exchange Holiday and Limited Trading

Q. In response to political and economic uncertainties in a foreign country, the government established a currency exchange holiday between December 20, 20X1 and January 11, 20X2. The trading market opened on January 11, 20X2, but there was limited trading, conducted primarily by individuals. The national bank, commercial banks, and business newspapers published various closing rates to buy U.S. dollars on January 11, 20X2 ranging from LC1.6 : \$1 to LC1.7 : \$1. What exchange rate should be used to translate an LC balance sheet into U.S. dollars as of December 31, 20X1?

A. While there was limited commercial trading activity on January 11, 20X2, LC was exchangeable for U.S. dollars on that date. Therefore, an enterprise should select an exchange rate as of that date using its standard procedures. That rate would be expected to be within the range of LC1.6 : \$1 to LC1.7 : \$1.

4.009 Other-Than-Temporary Lack of Exchangeability. If a lack of exchangeability between two currencies is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements should be carefully evaluated. This evaluation should consider whether the parent still controls, or has significant influence over, the foreign operation. ASC paragraph 810-10-15-10 provides that a majority-owned subsidiary should not be consolidated if control does not rest with the majority owner. For instance, control may not rest with the majority owner (parent) if the subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary. This limitation to consolidation should also be applied as a limitation to the use of the equity method. In these situations, which historically have been rare, the investment should be carried at cost and evaluated for other-than-temporary impairment.

4.010 Preference or Penalty Rates. Paragraph 3.016 discusses preference and penalty rates. ASC Topic 830 provides for translation of foreign currency financial statements at the rate at which cash flow returns on investment to the reporting entity from the foreign entity may be converted, which normally is the dividend remittance rate. Thus, the existence of preference or penalty rates for other than dividends normally has no effect on the translation process (i.e., when the local currency is the functional currency). A preference or penalty rate may, however, affect the elimination of intercompany balances in consolidation (see Paragraph 4.068).

4.011 Generally, if a preference rate for dividends is available, that rate should be used. However, in some situations it may be appropriate to use the free market rate as opposed to the official dividend rate. A lack of exchangeability due to economic conditions or exchange controls in the country in which the foreign entity is located is one of the circumstances in which it may be appropriate not to use the official dividend rate.

4.012 Black Markets. In countries with restrictive foreign exchange controls, frequently a black market for foreign currency exists. Acquisition of foreign currency on such markets usually represents a violation of government regulations. Businesses do not normally acquire foreign currency on such markets. Therefore translation of foreign currency financial statements at black market rates is not appropriate.

FOREIGN CURRENCY TRANSLATION

4.013 Equity Adjustment from Foreign Currency Translation. If an entity's functional currency is a foreign currency, the process of translating that entity's financial statements into the reporting currency results in translation adjustments. Translation adjustments originate from the effects of the difference between:

- Prior period-end rate and current period-end rate on translation of opening net assets;
- Transaction date (or weighted average) rates and current period-end rate on translation of income statement items; and
- Transaction date rates and current period-end rate on translation of contributions to and distributions from equity.

4.014 As discussed in Paragraph 4.002, translation adjustments can be viewed as unrealized gains or losses and, therefore, are not included in determining net income but are reported in other comprehensive income. Translation adjustments accumulated in other comprehensive income commonly are referred to as cumulative translation adjustments. ASC paragraph 830-30-45-12, Statement 52, par. 113

Example 4.1: Translation of Foreign Currency Financial Statements

Assumptions

A foreign subsidiary of a U.S. company with the local currency (LC) as its functional currency started business and acquired fixed assets at the beginning of the year when the LC/US\$ exchange rate was .95. The average exchange rate for the period was .90, and the rate at the end of the period was .85.

Translation of Foreign Subsidiary Financial Statements - December 31, 20X1

	LC	Rate	US\$
Balance Sheet			
Cash	20	.85	17
Receivables, net	80	.85	68
Inventory	300	.85	255
Fixed assets, net	600	.85	510
	<u>1,000</u>		<u>850</u>

4. Translation of Foreign Currency Financial Statements

Current liabilities	180	.85	153
Long-term debt	700	.85	595
Stockholders' equity:			
Common stock	100	.95	95
Retained earnings	20	^[1]	18
Accumulated other comprehensive income	--	^[2]	(11)
	<u>1,000</u>		<u>850</u>
Income Statement			
Revenue	130	.90	117
Cost of goods sold	(60)	.90	(54)
Depreciation	(20)	.90	(18)
Other expenses, net	(10)	.90	(9)
Income before taxes	40		36
Income taxes	(20)	.90	(18)
Net income	<u>20</u>		<u>18</u>
Statement of Comprehensive Income			
Net income			18
Other comprehensive income:			
Foreign currency translation adjustments		^[2]	(11)
Comprehensive income			<u>7</u>
Ratios			
Net income to revenue	.15		.15
Gross profit	.54		.54
Debt to equity	5.83		5.83
^[1] Retained earnings represents accumulated net income. Therefore, it is translated at the same rate as (accumulated) net income i.e., the individual historical rate related to each addition to retained earnings.			
^[2] The current year translation adjustment comprises two components:			
Translation difference on opening net assets (i.e.: opening equity)	LC100 x (0.85 - 0.95) =		\$(10)
Translation difference on net income	LC20 x (0.85 - .90) =		<u>(1)</u>
			<u>\$(11)</u>

4.015 As Example 4.1 illustrates, certain financial ratios are not affected by the translation. This is consistent with one of the objectives of translation; that is, to reflect in consolidated financial statements the financial results and relationships of the individual consolidated entities as measured in their functional currency. All ratios derived solely from balance sheet accounts will be unaffected by translation, as all assets and liabilities are translated at the same rate. Ratios derived solely from income statement accounts may be somewhat affected, if different rates are used for different income statement items. Ratios derived from both balance sheet and income statement accounts will be affected by translation.

Example 4.1a: Translation of Foreign Currency Financial Statements – Consolidation of Foreign Subsidiary and U.S. Parent

Consolidation of Foreign Subsidiary and U.S. Parent - December 31, 20X1

For illustration purposes the parent's pickup of the subsidiary's earnings is ignored in this example. The same assumptions apply as Example 4.1.

Translation of Foreign Subsidiary Financial Statements - December 31, 20X1

	U.S. Parent	Foreign Subsidiary	Eliminations	Consolidated
Balance Sheet				
Cash	\$50	\$17		\$67
Receivables, net	105	68		173
Inventory	250	255		505
Fixed assets, net	1,250	510		1,760
Investment in subsidiary, 100%	95	--	\$(95)	--
	<u>\$1,750</u>	<u>850</u>		<u>\$2,505</u>
Current liabilities	165	153		318
Long-term debt	300	595		895
Stockholders' equity:				
Common stock	800	95	\$(95)	800
Retained earnings	485	18		503
Accumulated other comprehensive income	--	(11)		(11)
	<u>\$1,750</u>	<u>\$850</u>		<u>\$2,505</u>
Income Statement				
Revenue	\$400	\$117		\$517
Cost of goods sold	(200)	(54)		(254)
Depreciation	(50)	(18)		(68)
Other expenses, net	(55)	(9)		(64)
Income before taxes	95	36		131
Income taxes	(53)	(18)		(71)
Net income	<u>\$42</u>	<u>\$18</u>		<u>\$60</u>

Statement of Comprehensive Income			
Net income	\$42	\$18	\$60
Other comprehensive income:			
Foreign currency translation adjustments	<u> --</u>	<u> (11)</u>	<u> (11)</u>
Comprehensive income	\$42	\$7	\$49

4.016 Statement of Cash Flows. ASC paragraph 830-230-45-1 states that a statement of cash flows of an enterprise with foreign currency transactions or foreign operations should report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average exchange rate for the period may be used for translation if the result is substantially the same as using the rates at the date of the individual cash flows. The statement of cash flows should report the effect of exchange rate changes on cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents held in foreign currencies as a separate item in the reconciliation of the change in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents during the period.

Example 4.2: Statement of Cash Flows

Assumptions

The LC/US\$ exchange rate at the beginning of the second year for the foreign subsidiary and the U.S. parent in Example 4.1 was .85 (the end of the period rate for the first year), and the average exchange rate for the period for both operating cash flows and income and expenses was .825. The exchange rate at the end of the second year was .80.

During the second year, the foreign subsidiary acquired fixed assets of LC100 (when the exchange rate was .875), issued additional long-term debt of LC120 (when the exchange rate was .775), and repaid LC20 debt ratably throughout the year.

The foreign subsidiary does not have any restricted cash or cash equivalents.

4. Translation of Foreign Currency Financial Statements

Translation of Foreign Subsidiary Financial Statements - December 31, 20X2	LC	Rate	US\$
Balance Sheet			
	40	.80	32
Cash	115	.80	92
Receivables, net	400	.80	320
Inventory	678	.80	542
Fixed assets, net	<u>1,223</u>		<u>986</u>
Current liabilities	279	.80	223
Long-term debt	800	.80	595
Stockholders' equity:			
Common stock	100	.95	95
Retained earnings	54	^[1]	46
Accumulated other comprehensive income	--	^[2]	(18)
	<u>1,223</u>		<u>986</u>
Income Statement			
Revenue	195	.825	161
Cost of goods sold	(90)	.825	(74)
Depreciation	(22)	.825	(18)
Other expenses, net	(15)	.825	(13)
Income before taxes	68		56
Income taxes	(34)	.825	(28)
Net income	<u>34</u>		<u>28</u>
Statement of Comprehensive Income			
Net income			28
Other comprehensive income:			
Foreign currency translation adjustments		^[2]	(7)
Comprehensive income			<u>\$21</u>
Statement of Cash Flows			
Cash flows from operating activities:			
Net income	34	.825	28
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	22	.825	18
Changes in assets and liabilities:			
Increase in receivables	(35)	.825	(29)
Increase in inventory	100	.825	(82)
Increase in current liabilities	99	.825	82
	<u>20</u>		<u>17</u>

4. Translation of Foreign Currency Financial Statements

Cash flows from investing activities:			
Fixed asset purchases	(100)	.875	(88)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	120	.775	93
Principal payments of long-term debt	<u>(20)</u>	.825	<u>(17)</u>
	<u>100</u>		<u>76</u>
Effect of exchange rate changes on cash		¹	10
Net increase in cash	20		15
Cash at beginning of year	<u>20</u>	.85	<u>17</u>
Cash at end of year	<u>40</u>	.80	<u>32</u>

¹ Retained earnings represent accumulated net income. Therefore it is translated at the same rate as (accumulated) net income.

² The cumulative translation adjustment is comprised as follows:

Translation difference on opening net assets (i.e.: opening equity)	LC120 x (0.80 – 0.85) =	\$6	
Translation difference on net income	LC34 x (0.80 – 0.825) =	<u>(1)</u>	
Current year translation adjustment		(7)	
Translation adjustment brought forward		<u>(11)</u>	
Cumulative translation adjustment		<u>\$(18)</u>	

³ The effect of exchange rate changes on cash is calculated as follows: ASC paragraph 830-230-55-15
Effect on cash at beginning of year:

Beginning cash balance at current year-end rate	LC20 x 0.80 =	\$16	
Beginning cash balance at prior year-end rate		<u>\$17</u>	\$(1)
Effect from operating cash flows:			
Operating cash flows at year-end rate	LC20 x 0.80 =	\$16	
Operating cash flows in statement of cash flows		<u>\$17</u>	(1)
Effect from investing activities			
Investing cash flows at year-end rate	LC100 x 0.80 =	\$(80)	
Investing cash flows in statement of cash flows		<u>\$(88)</u>	8
Effect from financing activities:			
Financing cash flows at year-end rate	LC100 x 0.80 =	\$80	
Financing cash flows in statement of cash flows		<u>\$76</u>	4
Effect of exchange rate changes on cash			<u>\$10</u>

Consolidation of Foreign Subsidiary and U.S. Parent - December 31, 20X2

For illustration purposes the parent's pickup of the subsidiary's earnings is ignored in this example.

	US Parent	Foreign Subsidiary	Eliminations	Consolidated
Balance Sheet				
Cash	\$40	\$32		\$72
Receivables, net	75	92		167
Inventory	350	320		670
Fixed assets, net	1,295	542		1,837
Investment in subsidiary, 100%	95	--	\$(95)	--
	<u>\$1,855</u>	<u>986</u>		<u>\$2,746</u>
Current liabilities	192	223		415
Long-term debt	315	640		955
Stockholders' equity:				
Common stock	800	95	\$(95)	800
Retained earnings	548	46		594
Accumulated other comprehensive income	--	(18)		(18)
	<u>\$1,855</u>	<u>\$986</u>		<u>\$2,746</u>
Income Statement				
Revenue	\$500	\$161		661
Cost of goods sold	(250)	(74)		(324)
Depreciation	(55)	(18)		(73)
Other expenses, net	(55)	(13)		(68)
Income before taxes	140	56		196
Income taxes	(77)	(28)		(105)
Net income	<u>\$63</u>	<u>\$28</u>		<u>\$91</u>
Statement of Comprehensive Income				
Net income	\$63	\$28		\$91

4. Translation of Foreign Currency Financial Statements

Other comprehensive income:				
Foreign currency translation adjustments	--	(7)		(7)
Comprehensive income	\$63	\$21		\$84
		US Parent	Foreign Subsidiary	Consolidated
Statement of Cash Flows				
Cash flows from operating activities:				
Net income		\$63	\$28	\$91
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation		55	18	73
Accrued interest on long-term debt		15		15
Changes in assets and liabilities:				
(Increase) decrease in receivables		(30)	(29)	1
Increase in inventory		(100)	(82)	(182)
Increase in current liabilities		27	82	109
		<u>90</u>	<u>17</u>	<u>107</u>
Cash flows from investing activities:				
Fixed asset purchases		<u>(100)</u>	<u>(88)</u>	<u>(188)</u>
Cash flows from financing activities:				
Proceeds from issuance of long-term debt		--	93	93
Principal payments of long-term debt		--	(17)	(17)
		<u>--</u>	<u>76</u>	<u>76</u>
Effect of exchange rate changes on cash				
		<u>--</u>	<u>10</u>	<u>10</u>
Net increase in cash		(10)	15	5
Cash at beginning of year		50	17	67
Cash at end of year		<u>\$40</u>	<u>\$32</u>	<u>\$72</u>

4.017 Effect of Subsidiary’s Foreign Currency Transaction Denominated in Parent’s Functional/Reporting Currency. A foreign entity whose functional currency is different from its parent’s functional/reporting currency may enter into transactions denominated in the parent’s functional/reporting currency. In the foreign entity’s functional currency financial statements these are foreign currency transactions that give rise to foreign exchange gains or losses in net income (see Paragraph 3.005). Those transaction gains or losses are not eliminated in the parent’s consolidated financial statements. Holding all other factors constant, translating the subsidiary’s functional currency financial statements, which will be consolidated with the parent’s financial statements, results in an equal and offsetting foreign currency translation adjustment in other comprehensive income. This is due to the effect on the parent company’s net investment in the subsidiary of the change in exchange rate between the subsidiary’s functional currency and the parent company’s functional currency. However, that process does create earnings volatility in the separate income statement of the subsidiary and the consolidated income statement of the parent.

Example 4.3: U.S. Dollar-Denominated Transactions of a Foreign Subsidiary

A foreign subsidiary of a U.S. parent company whose functional currency is the local currency (LC) sells products to a customer in the United States for \$100,000 on November 30, 20X1. The parent company’s functional/reporting currency is the U.S. dollar. The currency exchange rates at the transaction date and the balance sheet date of December 31, 20X1 are LC1 = US\$1.00 and LC1 = US\$.090, respectively, and the average rate for the month of December was LC1 = US\$.090. The U.S. GAAP functional currency (LC) financial statements of the foreign subsidiary as at December 31, 20X1 will reflect a foreign currency transaction gain in current income of LC 11,111 on the accounts receivable of \$100,000. The consolidated income statement of the parent company for the period ended December 31, 20X1 will reflect this LC 11,111 gain, after translation into U.S. dollars, even though the underlying transaction was denominated in U.S. dollars. However, holding all other factors constant, an equal and offsetting foreign currency translation loss will be included in the subsidiary’s translated U.S. dollar financial statements, as well as in the parent company’s currency translation account in equity. This outcome is illustrated below.

	Foreign Sub (Functional Currency: LC)	Foreign Sub (Translated US\$)
As at November 30, 20X1:		
Accounts receivable (\$100,000)	100,000	100,000
Retained earnings	100,000	100,000

4. Translation of Foreign Currency Financial Statements

As at December 31, 20X1:		
Accounts receivable	111,111	100,000
Retained earnings, beginning of month	100,000	100,000
Gain on US dollar receivable	11,111	10,000
Retained earnings, end of month	111,111	110,000
Currency translation adjustment to Accumulated Other Comprehensive Income, end of month	--	(10,000)
	<u>111,111</u>	<u>100,000</u>

¹ These balances will be reflected in the consolidated U.S. dollar financial statements of the parent.

Companies in these circumstances may consider hedging the U.S. dollar transactions of their foreign operations to reduce or eliminate this potential source of income statement volatility. See discussion in Section 5, *Foreign Currency Derivatives and Hedging Foreign Currency Risk*.

4.018 Translation of Accumulated Other Comprehensive Income. Accounting standards do not address the translation of amounts accumulated in other comprehensive income or what exchange rates to use when they are reversed into earnings (e.g., unrealized gains and losses on available-for-sale securities accounted for under ASC Subtopic 320-10, *Investments--Debt Securities - Overall*, unrealized gains and losses on derivative instruments designated as cash flow hedging instruments accounted for under ASC Topic 815, *Derivatives and Hedging*, and amounts related to pension and other postretirement benefit plans accounted for under ASC Topic 715, *Compensation--Retirement Benefits*). Based on discussions with the FASB staff, we believe that for purposes of foreign currency translation, an entity should view these amounts similar to retained earnings. Other comprehensive income elements should generally be translated at the exchange rates in effect at the dates on which the transactions included in other comprehensive income are recognized, or an appropriately weighted average exchange rate for the period, and accumulated other comprehensive income should generally be translated based on those historical exchange rates. When those elements are reclassified from accumulated other comprehensive income into earnings, we believe the same exchange rates used when the transactions were included in other comprehensive income would be used and retranslation at current exchange rates would not be performed. Entities need to develop policies and processes to track these amounts.

Example 4.4: Translation of Unrealized Gain on Cash Flow Hedging Instrument Accumulated in Other Comprehensive Income

Assumptions

Company A, a U.S. dollar functional currency company, has a foreign subsidiary whose local currency (LC) is its functional currency. The foreign subsidiary accounts for an interest rate swap as a hedging derivative in a cash flow hedge under ASC Topic 815. Assume the following:

Unrealized gain – beginning of the period (in functional currency)	LC10,000
Unrealized gain – beginning of the period (in reporting currency)	\$8,500
Unrealized gain – end of the period (in functional currency)	LC15,000
Weighted average exchange rate during the period, absent evidence that significant changes in fair value of the derivative occurred during times of significantly different exchange rates	0.91 \$/LC

Example Translation

	Functional Currency	FX Rate	Reporting Currency
Unrealized gain - beginning of the period	LC10,000		\$8,500
Change in unrealized gain	<u>5,000</u>	.91	<u>4,550</u>
Unrealized gain - end of period	<u>LC15,000</u>		<u>\$13,050</u>

4.019 An entity also may apply an alternative approach when translating amounts in accumulated other comprehensive income related to pension and other postretirement benefit plans (e.g., prior period service costs or credits, actuarial gains or losses, and net transition assets or obligations) and when reclassifying them into earnings. When such pension-related balances are amortized and recognized in earnings as a component of net periodic pension cost, we believe that an entity may make an accounting policy election to use either (1) a historical exchange rate method, as described in Paragraph 4.018 or (2) a current exchange rate method.

4.020 If a current exchange rate method is used, pension-related amounts reclassified from accumulated other comprehensive income into earnings as a result of amortization would be translated at the exchange rate in effect during the period of reclassification. Because amortization of these items occurs throughout the period rather than at a specific point in time, the weighted-average exchange rate for the period typically would be used. Pension-related amounts remaining in accumulated other comprehensive income at the

end of the reporting period would be translated into the reporting currency at the period-end exchange rate.

4.021 We believe that a current exchange rate method is an acceptable alternative to a historical exchange rate method because it is consistent with the Board's view that the adoption of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (Statement 158; codified in ASC Topic 715) should not change the approach to measuring the net periodic pension cost. Before the adoption of Statement 158, certain amounts now recognized in accumulated other comprehensive income (e.g., prior period service costs or credits, actuarial gains or losses, and net transition assets or obligations) were disclosed in the notes to the financial statements, but were not recognized in the balance sheet. When these unrecognized amounts were amortized into earnings as part of the net periodic pension cost, the current exchange rate was used for translation purposes under ASC paragraph 830-30-45-3. Therefore, electing to use a current exchange rate method when reclassifying pension-related amounts from accumulated other comprehensive income to earnings and for translating the related amounts in accumulated other comprehensive income following Statement 158's adoption is consistent with the FASB's intent because use of a current exchange rate would not alter the manner in which the net periodic pension cost is recognized.

Example 4.5: Translation of Adjustments to Unrecognized Pension Costs Recorded in Other Comprehensive Income Using a Current Exchange Rate Method

Assumptions

Company A, a U.S. dollar functional currency company, has a foreign subsidiary whose local currency (LC) is its functional currency. The foreign subsidiary sponsors a defined benefit pension plan that is accounted for under the provisions of ASC Topic 715. In this example, assume that plan assets equal the projected benefit obligation at the beginning of 20X1. Further, assume that Company A is not required to amortize the cumulative net gain because it represents less than 10 percent of the greater of the projected benefit obligation or market-related value of plan assets for all years presented.

The following items (in LC) have not yet been recognized by Company A as a component of net periodic pension cost:

	1/1/X1	12/31/X1	1/1/X2	12/31/X2
Prior Service Cost	500	450	400	350
Net Gain	(750)	(575)	(450)	(525)
	<u>(250)</u>	<u>(125)</u>	<u>(50)</u>	<u>(175)</u>

During 20X1, 20X2, and 20X3, Company A adjusts accumulated other comprehensive income to:

4. Translation of Foreign Currency Financial Statements

- Recognize amortization of prior service cost in the net periodic pension cost (i.e., amount is reclassified out of accumulated other comprehensive income and into earnings through net periodic pension cost); and
- Recognize net gain or loss for the period (i.e., the difference between actual and expected return on plan assets for period and changes in actuarial assumptions). The offset to the amount recorded in accumulated other comprehensive income is recognized as an adjustment to the recognized net pension asset or liability.

The following table illustrates the adjustments made to accumulated other comprehensive income for these items (in LC) during 20X1, 20X2, and 20X3:

	20X1	20X2	20X3
Amortization of Prior Service Cost	(50)	(50)	(50)
Net (Gain)/Loss	175	125	(75)
Other Comprehensive (Income)/Loss	<u>125</u>	<u>75</u>	<u>(125)</u>

During 20X1, 20X2, and 20X3, exchange rates (US\$:LC) were as follows:

	20X1	20X2	20X3
Spot Rate - Beginning of Year	0.90	1.00	1.10
Spot Rate - End of Year	1.00	1.10	1.20
Weighted Average Annual Rate	0.95	1.05	1.15

Example Translation - Current Exchange Rate Method

Under a current exchange rate method, Company A translates other comprehensive income for the period, including all adjustments made to unrecognized net periodic pension costs in accumulated other comprehensive income, into the reporting currency using the exchange rate in effect on the dates on which the transactions included in other comprehensive income are recognized. In this case, a weighted-average exchange rate for the year is used because amortization occurs throughout the period rather than at a specific point in time. Pension-related amounts remaining in accumulated other comprehensive income at the end of the reporting period would be translated into the reporting currency at the period-end exchange rate. Any resulting difference between accumulated other comprehensive income translated at the year-end spot rate and the cumulative amount recorded in Company A's consolidated other comprehensive income balance is reflected as a component of the cumulative translation adjustment balance. The following table illustrates a current exchange rate method:

4. Translation of Foreign Currency Financial Statements

	Reporting Currency (US\$) - AOCI					
	Functional Currency (LC) - AOCI	FX Spot Rate	FX Weighted Avg. Rate	Pension Items	CTA	Total
1/1X1	(250)	0.90		(225)		(225)
20X1-OC1	125		0.95	119		119
12/31/X1	(125)	1.00		(10)	(19)	(125)
20X2-OC1	75		1.05	79	(9)	70
12/31/X2	(50)	1.10		(27)	(28)	(55)
20X3-OC1	(125)		1.15	(144)	(11)	(155)
12/31/X3	(175)	1.20		(171)	(39)	(210)

4.022 Translation of Instruments Classified as Temporary Equity – ASC paragraph 480-10-S99-3A. Paragraph 3.070 discusses the appropriate exchange rate to use when translating an instrument classified as temporary equity under ASC paragraph 480-10-S99-3A (formerly EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities*) from the functional currency into an entity's reporting currency.

4.022a Translation of Treasury Stock. The repurchase of an entity's own outstanding common stock (treasury stock) is translated using the current exchange rate at the time of the transaction. We believe the repurchase of stock is a separate and distinct transaction that is not tied or linked to the original issuance of the instrument. Therefore, it is accounted for like any current transaction using current exchange rates. The entire current value of the transaction reduces equity and is subsequently translated at the exchange rate in effect at the time of the repurchase.

ACCOUNTING FOR A CHANGE IN FUNCTIONAL CURRENCY

4.023 ASC paragraphs 830-10-45-7 and 45-8 confirm that a change in the functional currency is not a change in accounting principle as defined in ASC Topic 250, *Accounting Changes and Error Corrections*. Accordingly, previously issued financial statements should not be restated for any change in the functional currency (i.e., functional currency changes are not applied retroactively). ASC paragraphs 830-10-45-8

4.024 The FASB staff stated that the same accounting (i.e., the cumulative translation adjustment remains in equity) applies on introduction of the euro in member countries of the European Union. We believe that this applies in situations in which the functional currency changes from a foreign currency to the reporting currency due to replacement of that foreign currency by the reporting currency.

4.024a If the functional currency changes from a foreign currency to the reporting currency, the cumulative translation adjustments of prior periods are not removed from equity. The exchange rate on the date of the change becomes the historical rate for subsequent remeasurement of nonmonetary assets and liabilities into the new functional currency. For both monetary and nonmonetary assets and liabilities, the translated balances at the end of the prior period become the new accounting basis in the opening

balance sheet for the first financial statement period that uses the new functional currency. ASC paragraph 830-10-45-10

4.025 A change in functional currency from the reporting currency to a foreign currency requires restatement (but not prior period restatement) of nonmonetary assets and liabilities. The accounting basis of the nonmonetary assets and liabilities (e.g., fixed assets remeasured at the historical exchange rate before the change and translated at the current exchange rate after the change) are adjusted to reflect the difference between the exchange rate when the asset or liability arose and the exchange rate on the date of the change in functional currency. This effect is reported in other comprehensive income as of the date of the change. The change in functional currency from reporting currency to foreign currency for monetary items has no effect because these items are remeasured/translated to the reporting currency at current exchange rates before and after the change. ASC paragraphs 830-10-45-9 and 45-10

4.026 A change in the functional currency should be reported as of the date the change occurs, which might be any point within the year. In practice, a change in functional currency generally is reported as of the beginning of a fiscal quarter.

Example 4.6: Accounting for a Change in Functional Currency

Company A (a U.S. company) acquired Subsidiary B (a foreign company), which was to be used as a sales office for Company A's products in the foreign country. The functional currency is considered to be the reporting currency. The exchange rate on the date of acquisition is \$2 = LC1. Two years later, Company A decides to have Subsidiary B build a plant and use its sales office as the main sales office for the new plant's products. The new manufacturing facility will have little, if any, effect on Company A's cash flows because all borrowings will be Subsidiary B's obligations and its profits will be used either to fund future growth or to pay down its own obligations. As a result of the significant changes in the economic facts and circumstances, Subsidiary B changes its functional currency to the local currency. The exchange rate on this date \$2.50 = LC1. Assume the following balance sheet at the date of the change.

	LC	\$ Remeasurement Before Change in Functional Currency	\$ Translation After Change
Cash	100	250	250
Accounts Receivable	400	1,000	1,000
Fixed Assets	500	1,000 ¹	1,250
Total Assets	1,000	2,250	2,500
Notes Payable	(300)	(750)	(750)
Equity	700	\$1,500 ¹	\$1,750

¹ At historical rates.

The \$250 increase in fixed assets reflects the change in the exchange rate from the date Company A acquired Subsidiary B to the date of the change in functional currency $((2.50-2.00) \times 500)$. This gain is reported in other comprehensive income. The change in functional currency from the foreign to reporting currency for monetary items has no effect, because these items are remeasured/translated to the reporting currency at current exchange rates before and after the change.

Q&A 4.2: Change in Functional Currency of Parent Company

Q. Company A, a non-U.S. company, prepares its financial statements in accordance with U.S. GAAP using its local currency as the functional currency and reporting currency. Due to significant changes in economic facts and circumstances, Company A's functional currency changes to the U.S. dollar. How should Company A account for this change in functional currency if it (1) maintains the local currency as its reporting currency, or (2) changes its reporting currency to the U.S. dollar?

A. (1) If the functional currency changes from the reporting currency (the local currency) to a foreign currency (the U.S. dollar), nonmonetary assets and liabilities should be remeasured into U.S. dollars at historical exchange rates, and the U.S. dollar financial statements should be translated into the reporting currency at the current exchange rate. Company A should recognize the net effect of the adjustments to the accounting basis of the respective nonmonetary assets and liabilities in other comprehensive income in accordance with ASC paragraph 830-10-45-9. Going forward, as Company A does not maintain its books of record in its new functional currency, it will be required to remeasure its books of record into its functional currency before translating them into its reporting currency.

(2) If Company A also changes its reporting currency, the functional currency will be the reporting currency. After the initial change in functional currency is accounted for as outlined under (1) above, Company A will need only to remeasure its books of record into the new functional/reporting currency, and no translation is required going forward. If Company A were an SEC registrant, it would have to recast comparative information for prior periods into the new reporting currency as if the new reporting currency had been used since at least the earliest period presented. Regulation S-X, Rule 3-20(e)

4.027 Goodwill and Fair Value Purchase Adjustments. Goodwill and other fair value purchase adjustments of a foreign entity acquired in a purchase transaction represent assets and/or liabilities of the acquired foreign entity, regardless of whether the purchase accounting adjustments are pushed down to the foreign entity. Therefore, they must be measured in the functional currency of the acquired entity, and, if the local currency is the functional currency of the foreign entity, be translated at current exchange rates. As a consequence, this translation will affect the cumulative translation adjustment. ASC paragraphs 830-10-15-6, 830-30-45-11

4.028 ASC paragraph 350-20-35-41 designates the reporting unit as the unit of accounting at which goodwill is tested for impairment and requires goodwill to be assigned to reporting units of the acquiring entity that are expected to benefit from the synergies of the combination even though other assets and liabilities of the acquired entity may not be assigned to that reporting unit. ASC Topic 350, *Intangibles--Goodwill and Other*, does not change the guidance for determining the functional currency of goodwill in accordance with ASC Topic 830. See question 5.4.120 and example 5.4.40 of KPMG Handbook, [Impairment of nonfinancial assets](#), for additional guidance on the allocation of goodwill and impairment testing.

4.029 Multilevel Consolidation. In preparing consolidated financial statements, an enterprise should apply the translation requirements of ASC Topic 830 at each level in the consolidation, starting with the lowest level parent and working upward (i.e., each successive parent in the structure would prepare its own consolidated financial statements in accordance with ASC Topic 830 by translating and consolidating the consolidated financial statements of each entity directly beneath it).

Q&A 4.3: Multilevel Consolidation

Q. A U.S. parent company has a subsidiary with a foreign currency as the functional currency that in turn has a subsidiary with the U.S. dollar as the functional currency. The intermediate subsidiary has hedged its investment in its subsidiary with a U.S. dollar loan. How should that loan be accounted for in consolidation?

A. The intermediate subsidiary would exclude exchange gains and losses on the loan from net income and report them in other comprehensive income in its consolidated financial statements in accordance with ASC paragraph 830-20-35-3(a), as discussed in detail in Section 5. This treatment would be carried through without adjustment into the parent's consolidated financial statements. It would be inappropriate from the parent's perspective not to view the second-tier subsidiary as a foreign entity within the meaning of ASC Topic 830 and to reverse the hedge accounting applied by the intermediate subsidiary.

4.030 Equity Method Investments. Foreign currency translation under ASC Topic 830 should not result in differences in shareholders' equity between an investment that is consolidated and an investment that is accounted for by the equity method in a reporting entity's financial statements. If an investor accounts for an investment in a foreign entity using the equity method, the investor's financial statements should report a translation adjustment in other comprehensive income. Thus, two equity pickups for a foreign investee would be recognized: ASC paragraph 830-10-15-5

- The net income pickup (investor's ownership percentage of investee's translated net income).

- The other comprehensive income pickup, including the investor's share of any cumulative translation adjustment on the books of the investee. An additional translation adjustment would arise from translation of the investee's financial statements into the investor's functional currency.

Q&A 4.4: Equity Method Goodwill

Q. Should goodwill arising from an investment in a foreign entity accounted for under the equity method be considered a foreign currency-denominated asset?

A. Yes. ASC paragraph 323-10-35-13, states, "a difference between the cost of an investment and the amount of underlying equity in net assets of an investee shall be accounted for as if the investee were a consolidated subsidiary." Accordingly, goodwill and other fair value adjustments resulting from an equity method investment in a foreign entity should be considered denominated in the functional currency of the investee and translation adjustments should be included in other comprehensive income.

4.031 Noncontrolling Interests. The amount of translation adjustments in other comprehensive income that relates to noncontrolling interests should be allocated to and reported as part of the noncontrolling interests in the consolidated financial statements. ASC paragraph 830-30-45-17

IMPAIRMENT

4.032 Measurement of assets of a foreign entity in its functional currency in accordance with ASC paragraph 830-10-45-2 includes application of impairment tests and lower of cost or market tests on the basis of that functional currency. Relevant inputs for those tests (e.g., cash flows, fair values, market values, etc.) should be determined in the foreign entity's functional currency and must be compared to the functional currency carrying amount of the respective asset. Impairment issues related to foreign currency transactions are discussed in Paragraphs 3.025-3.034 and 3.051-3.053. Upon translation into the reporting currency, no reevaluation of impairment occurs.

4.033 Impairment of Equity Method Investment. An impairment evaluation of an investment in a foreign entity accounted for by the equity method should be done in the investor's functional currency. If the investee's functional currency is different from the investor's functional currency, the carrying amount of the investment is the amount after foreign currency translation, including equity method goodwill and fair value purchase accounting adjustments. This amount will fluctuate with changes in the exchange rate. ASC paragraphs 830-30-45-12 and 830-30-40-1 indicate that an enterprise should include translation adjustments in equity, and not in earnings, except upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity. Therefore, if the equity method investment is to be held and used, the amount of any cumulative translation adjustment should not influence the impairment evaluation. For a discussion

of impairment of an investment to be disposed of, either for equity method or consolidated investees, see Paragraph 4.035.

Example 4.7: Impairment of Equity Method Investment

A U.S. enterprise invested US\$100 in a foreign entity whose functional currency is the local currency (LC) when the exchange rate was US\$1 = LC1. After the date of the investment, the foreign entity's operations have broken even and the current exchange rate is US\$1 = LC5. At the balance sheet date the cumulative translation adjustment would be US\$80, and the carrying amount of the investment (subject to impairment evaluation) would be US\$20. If the enterprise intends to hold and use the investment and is able to demonstrate that it will recover at least US\$20 from the investment, the enterprise's investment in the foreign entity would not be impaired.

4.034 Goodwill Impairment. ASC paragraph 350-20-35-4 requires enterprises to test goodwill for impairment by comparing the fair value of a reporting unit with its carrying amount. The carrying amount of a consolidated foreign entity that comprises all or part of a reporting unit in which goodwill is tested for impairment is the net amount at which the assets and liabilities of the foreign entity are reported in the enterprise's consolidated balance sheet (i.e., after foreign currency translation). The amount of any cumulative translation adjustment should not influence the impairment evaluation if the foreign entity is to be held and used. Paragraph 4.035 addresses evaluation of an impairment of an investment to be disposed of. Only goodwill related to a consolidated entity is tested for impairment in accordance with ASC Topic 350. The evaluation of equity method goodwill is subsumed into the evaluation for impairment of the investment in the equity method investee in total, as discussed in Paragraph 4.033.

4.034a In January 2017, the FASB issued ASU 2017-04, *Simplifying the Test for Goodwill Impairment*, which replaces the two-step impairment test for goodwill with a one-step test that both identifies and measures goodwill impairment. Under the ASU, an entity compares the fair value of the reporting unit to its carrying amount. If impairment is identified, the entity records that difference as an impairment loss. This ASU eliminates the previous requirement under Step 2 to perform a hypothetical purchase price allocation to measure goodwill impairment. See KPMG Handbook, [Impairment of nonfinancial assets](#), for in-depth discussion of the subsequent accounting for goodwill, including the goodwill impairment model, private company alternative and accounting for the disposition of all or a portion of a reporting unit. Once an entity has adopted ASU 2017-04, it must apply the one-step approach to all goodwill impairment tests going forward. See Appendix A of KPMG Handbook, *Impairment of nonfinancial assets*, for further discussion of the adoption of ASU 2017-04.

Example 4.8: Goodwill Impairment Test

Prior to the adoption of ASU 2017-04, the first step of the goodwill impairment test under ASC Topic 350, which is used to identify potential impairment, is to compare the fair value of the reporting unit with its carrying amount, including goodwill. Step two of the impairment test requires comparing the calculated implied fair value of goodwill with its carrying amount.

Assume the following values for the reporting unit:

Assets (including goodwill)	\$100
Liabilities	(60)
Net assets	<u>\$40</u>
Retained earnings and common stock	\$(48)
Cumulative translation adjustment	<u>8</u>
Total equity	<u><u>\$(40)</u></u>

In this example the carrying amount of net assets for the reporting unit for step one of the impairment test would be \$40. For step two of the impairment test, none of the cumulative translation adjustment (\$8) would be allocated to the recorded amount of goodwill when comparing the implied fair value of goodwill with the recorded amount of goodwill.

4.035 Impairment of an Investment in a Foreign Entity to Be Disposed of. ASC paragraphs 830-30-45-13 through 45-15 state that an entity that has committed to a plan to dispose of an equity method investment or a consolidated investment in a foreign entity that will cause the cumulative translation adjustment attributable to that entity to be reclassified to earnings includes the cumulative translation adjustment as part of the carrying amount of the investment when evaluating that investment for impairment. As discussed in Question 5.3.80 of KPMG Handbook, [Impairment of nonfinancial assets](#), we believe that whether management is committed to a plan of disposal should be based on the criteria to classify an asset (disposal group) as held-for-sale. See chapter 4 of KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#), for guidance on held-for-sale criteria. Additionally, there may be situations where the cumulative translation adjustment associated with a foreign entity is in a cumulative loss position (i.e., debit balance) resulting in an impairment amount that is more than the carrying amount of the investment. See question 4.5.120 and example 4.5.20 of KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#), for additional guidance in these situations. Further, an entity includes the portion of the cumulative translation adjustment that represents a gain or loss from an effective hedge of the net investment in a foreign entity in accordance with ASC paragraph 830-20-35-3(a) as part of the carrying amount of the investment to be disposed of when evaluating that investment for

impairment. For evaluating impairment of an investment to be held and used, see Paragraphs 4.033-4.034.

Q&A 4.5: Intercompany Transaction of a Long-Term Investment Nature

Q. Should an enterprise include the portion of the cumulative translation adjustment that represents a gain or loss arising on a foreign currency loan of a long-term investment nature to a consolidated foreign subsidiary or foreign equity method investee in accordance with ASC subparagraph 830-20-35-3(b) as part of the carrying amount of its investment in that entity when evaluating that investment for impairment, if the enterprise has committed to a plan to dispose of the investment that will cause the cumulative translation adjustment attributable to that entity to be reclassified to earnings?

A. Yes. ASC paragraphs 830-30-45-13 through 45-15 require that the cumulative translation adjustment for the foreign entity should be included in the carrying amount of the investment in those circumstances. ASC paragraph 830-20-35-3(b) requires that transaction gains and losses on intercompany foreign currency transactions of a long-term investment nature should be “reported in the same manner as translation adjustments.” Accordingly, the enterprise should treat those gains and losses in the same manner as translation adjustments for the purpose of evaluating the investment in the foreign entity for impairment.

SALE, EXCHANGE, OR LIQUIDATION OF AN INVESTMENT IN A FOREIGN ENTITY

4.036 Complete Sale or Substantial Liquidation of an Investment in a Foreign Entity. As discussed in Paragraph 4.002, translation adjustments reported in accumulated other comprehensive income can be viewed as unrealized gains or losses. According to ASC paragraph 830-30-40-1, the amount attributable to a foreign entity included in the translation adjustment component of accumulated other comprehensive income in stockholders’ equity should be reported as part of the gain or loss upon the complete sale or upon complete or substantially complete liquidation of that foreign entity. Accordingly, accounting records should be maintained in a manner that will allow the identification of that portion of the cumulative translation adjustment that relates to each investment, particularly foreign entities, because the amount related to each investment should be reported in the income statement as part of the gain or loss on sale or liquidation of the investment. See Paragraph 4.049 for additional guidance on how substantial liquidation is interpreted.

4.037 The cumulative translation adjustment that is a part of the net gain or loss on the complete sale or upon complete or substantially complete liquidation of an investment in a foreign entity should be reported in the income statement in the same period in which the gain or loss on sale or liquidation is recognized under generally accepted accounting

principles. ASC paragraph 830-30-40-4 indicates that this provision of ASC Topic 830 does not alter the period in which a gain or loss on disposal of part or all of a net investment is recognized under generally accepted accounting principles. Accordingly, if an entity expects a loss on the disposal of a foreign entity, it should report the portion of the cumulative translation adjustment that relates to that foreign entity in the income statement as part of the loss on disposal in the same period it reports the transaction in the income statement. This requirement was confirmed in ASC paragraphs 830-30-45-13 through 45-15, which is discussed in Paragraph 4.035. See paragraphs 2.001 to 2.003 for a discussion on the definition of a foreign entity.

4.038 Sale of Part of an Investment in a Consolidated Foreign Entity. Entities should follow the guidance within ASC Subtopic 810-10, *Consolidation - Overall*, to determine the accounting for translation adjustments reported in accumulated other comprehensive income when an entity sells part of its ownership interest in a consolidated foreign entity. Under ASC Subtopic 810-10, the accounting treatment for the translation adjustment is determined based on whether or not the parent retains a controlling financial interest in the foreign entity upon completion of the partial sale.

4.039 If the parent retains a controlling financial interest in the foreign entity after the partial sale, the parent would account for the sale as an equity transaction under ASC paragraph 810-10-45-23 and no gain or loss related to the transaction would be recognized in earnings. Accordingly, ASC paragraph 830-30-40-3 states that no cumulative translation adjustment is released into net income for a partial sale when the parent retains a controlling financial interest. In these situations, we believe that a pro rata share of the cumulative translation adjustment related to the interest sold should be transferred from the cumulative translation adjustment account reported in accumulated other comprehensive income to the noncontrolling interest account at the time of the sale. Reclassifying a pro rata share of the translation adjustment account to the noncontrolling interest account at the time of the sale is consistent with (a) the guidance in ASC paragraph 810-10-45-23, which indicates that transactions where the parent retains control are equity in nature (e.g., movement in translation adjustments should be between equity accounts) and (b) the accounting under ASC Subtopic 810-10 of allocating accumulated other comprehensive income (including translation adjustment) accounts between the controlling interest and noncontrolling interests during each reporting period going forward.

4.040 In situations where the parent does not retain a controlling financial interest in the foreign entity as a result of a partial sale, the parent would deconsolidate the foreign entity in accordance with ASC paragraph 810-10-40-5 and record a gain or loss related to (1) the retained interest held by the parent in the foreign entity and (2) the equity interest that was sold. Accordingly, the entire balance within the parent's cumulative translation adjustment account related to the foreign subsidiary should be recognized in earnings at the time of sale because the parent no longer has control in accordance with ASC paragraph 810-10-40-4A, regardless of whether or not the parent has significant influence over the foreign entity.

4.041 Other Events That May Result in the Loss of a Controlling Financial Interest of an Investment in a Foreign Entity. In addition to the sale of all or part of its ownership interest, ASC paragraphs 810-10-15-10 and 55-4A describe other circumstances that may preclude consolidation or result in the parent losing controlling financial interest in a foreign subsidiary. The examples include:

- Subsidiaries in legal reorganization or bankruptcy;
- 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;
- Cases where the powers of a shareholder with a majority voting interest are restricted by certain approval or veto rights held by minority shareholders;
- The expiration of a contractual arrangement that provided the parent with a controlling financial interest;
- Issuance of shares by the subsidiary that dilutes the parent's ownership interest so that the parent no longer has a controlling financial interest; and
- Situations where the subsidiary becomes subject to the control of a government, court, administrator, or regulator.

4.042 When the parent does not retain a controlling financial interest in the foreign entity for one of the reasons cited in Paragraph 4.041, it would deconsolidate the foreign entity and record a gain or loss in accordance with ASC paragraph 810-10-40-5 if the foreign entity (1) is a business and (2) is not in-substance real estate. Even though the parent does not sell any of its equity interests in the foreign entity in these situations, any translation adjustment balance within the parent's cumulative translation adjustment account related to the foreign entity being deconsolidated should be recognized in earnings at the time of deconsolidation in accordance with ASC paragraph 810-10-40-4A because the parent no longer has control.

Q&A 4.6: Initial Public Offering of Shares in a Foreign Subsidiary

Q. How should an enterprise account for the cumulative translation adjustment when there is an initial public offering of stock in a foreign subsidiary?

A. As discussed in Paragraph 4.039, if the enterprise retains a controlling financial interest in the foreign subsidiary after the transaction, the parent would account for the IPO as an equity transaction under ASC paragraph 810-10-45-23 and no gain or loss related to the transaction would be recognized in earnings. In accordance with ASC paragraph 830-30-40-3, it would be inappropriate to recognize any of the cumulative translation adjustment in earnings at the time of sale because the enterprise retains a controlling financial interest in the foreign subsidiary after the transaction.

In situations where the enterprise does not retain a controlling financial interest in the foreign subsidiary as a result of an IPO, it would deconsolidate the foreign subsidiary in accordance with ASC paragraph 810-10-40-5 and record a gain or loss related to (1) the retained interest it holds in the foreign subsidiary and (2) the equity interest that was sold. In accordance with ASC paragraph 810-10-40-4A, the entire balance within the enterprise's cumulative translation adjustment account related to the foreign subsidiary should be recognized in earnings at the time of sale, because the enterprise no longer has control (regardless of whether or not the parent has significant influence over the foreign subsidiary).

Example 4.9: Loss of Control Upon a Foreign Subsidiary's Bankruptcy Filing

Company A (functional U.S. dollar entity) owns a 100% equity interest in Subsidiary X (functional Philippine peso entity) as of December 31, 201X. After year-end, Subsidiary X files for bankruptcy in its local jurisdiction. As a result of the filing, the bankruptcy court, rather than Company A's management, has control over all operational and strategic decisions of Subsidiary X. ASC paragraph 810-10-55-4A states that deconsolidation is required when "...the subsidiary becomes subject to the control of a government, court, administrator, or regulator." ASC paragraph 810-10-15-10 indicates that controlling financial interests do not exist if a subsidiary is in bankruptcy or legal reorganization. Because Company A no longer holds a controlling financial interest after the bankruptcy filing (even though it still holds a 100% equity interest in Subsidiary X), management deconsolidates Subsidiary X and records a gain or loss under ASC paragraph 810-10-40-5. At the time of the bankruptcy filing, Company A has a cumulative translation gain of \$1,000,000 within its cumulative translation adjustment account related to Subsidiary X's operations.

In this example, the entire cumulative translation gain of \$1,000,000 within Company A's cumulative translation adjustment account should be recognized in earnings at the time of deconsolidation in accordance with ASC paragraph 810-10-40-4A because Company A no longer has control, even though it retains a 100% equity interest in Subsidiary X.

4.043 Sale of, or Part of, an Equity Method Investment in a Foreign Entity. Under ASC paragraph 830-30-40-2, if an entity sells part of its equity method investment in a foreign entity, a pro rata portion of the cumulative translation adjustment attributable to that investment should be recognized in measuring the gain or loss on sale.

4.043a As discussed in Paragraph 4.036, if the entity sells its entire equity method investment in a foreign entity, it recognizes all of the cumulative translation adjustment balance attributable to that investment in measuring the gain or loss on sale. Based on the guidance in ASC paragraph 830-30-40-1A, the sale of an investment in a foreign entity includes events that result in an acquirer obtaining control of an acquiree in which it held

an equity interest immediately before the acquisition date (also referred to as a step acquisition). Accordingly, any cumulative translation adjustment related to an equity method investment that is a foreign entity would be released into earnings as part of the gain or loss upon the acquirer obtaining control of the acquiree in a step acquisition.

4.044 ASC paragraph 323-10-40-1 states that an equity method investor should account for a share issuance by an investee as if the investor had sold a proportionate share of its investment and that any gain or loss associated with the share issuance should be recognized in earnings. In these situations, we also believe that the investor should recognize a pro rata portion of the cumulative translation adjustment attributable to the proportionate reduction in the investor's interest in measuring the gain or loss on sale.

Example 4.10: Sale of Part of an Equity Method Investment in a Foreign Entity When Significant Influence Is Retained

Company A (functional U.S. dollar entity) owns a 45% equity interest in Entity X (functional Philippine peso entity) as of December 31, 201X. While Company A lacks a controlling financial interest in Entity X, it has the ability to exercise significant influence over its operating and/or financial decisions. Accordingly, Company A accounts for its investment using the equity method under ASC Topic 323, *Investments--Equity Method and Joint Venture*. After year-end, Company A sells one-third of its equity interest in Entity X to Company B, which is an independent third party. Because Company A retains significant influence after the sale (i.e., it retains a 30% equity interest in Entity X), it continues to account for its investment under the equity method. At the time of the sale, Company A has a cumulative translation gain of \$1,000,000 within the cumulative translation adjustment account related to the equity method investment.

In accordance with ASC paragraph 830-30-40-2, a pro rata portion of the accumulated translation adjustment attributable to Entity X should be recognized in earnings at the time of the sale. In this case, one-third of the cumulative translation adjustment balance, or \$333,000, would be recognized in earnings.

Example 4.11: Sale of Part of an Equity Method Investment in a Foreign Entity When Significant Influence Is Not Retained

Assume the same facts as in Example 4.10, except that Company A only retains a 5% cost method investment in Entity X after the sale (i.e., Company A no longer has significant influence over Entity X). At the time significant influence is lost (e.g., upon the sale of its partial interest in Entity X), it would recognize a pro rata portion of the accumulated translation adjustment attributable to Entity X in earnings. In this case, Company A would recognize 88.9% (40%/45%) of the cumulative translation adjustment balance, or \$889,000 in earnings. The remaining carrying amount of the

investment under the equity method becomes the carrying amount under the cost method. When transitioning from equity method accounting to the cost method, ASC paragraph 323-10-35-39 requires Company A to offset the remaining \$111,000 cumulative translation adjustment balance related to its investment in Entity X against the carrying amount of the investment (i.e., its cost method investment) at the time significant influence is lost. To the extent the offset (i.e., cumulative translation adjustment amounts) results in a carrying amount of the investment that is less than zero (i.e., the remaining cumulative translation adjustment balance is a credit amount greater than the cost method investment), Company A should (a) reduce the carrying amount of the investment to zero and (b) record the remaining amount in income.

4.045 Sale of a Foreign Entity's Net Assets. Parent entities may enter into transactions to sell a group of net assets within a consolidated foreign entity to an independent third party while retaining 100% equity interest in the subsidiary. In many cases, the disposition of the net asset group would not constitute a substantial liquidation of the foreign subsidiary (e.g., the net assets sold would be less than 90% of the foreign subsidiary's net assets; see discussion in Paragraph 4.049). However, if the group of net assets sold meets the definition of a business as contemplated in ASC Topic 805, *Business Combinations*, the parent entity would derecognize the group of assets and record a gain or loss on the sale under ASC paragraph 810-10-40-5. For purposes of this discussion, the concept of net asset groups includes subsidiaries but does not include conveyances of oil and gas mineral rights. For guidance on transactions related to oil and gas mineral rights, see ASC Topic 932, *Extractive Activities--Oil and Gas*.

4.046 If the parent has a cumulative translation adjustment balance associated with the foreign entity, the parent would need to determine whether the sale represents a complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided.

4.047 According to ASC paragraph 810-10-40-4A, when a parent ceases to have a controlling financial interest in a subsidiary or group of assets within a foreign entity, the parent is required to apply the guidance in Subtopic 830-30 to determine whether to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. If the sale does not represent a complete or substantially complete liquidation of a foreign entity, then no amount of the cumulative translation should be released into earnings. Paragraph 4.052 provides factors to consider when determining whether a second-tier subsidiary is a foreign entity and the accounting for the cumulative translation adjustment account in that circumstance.

Q&A 4.7: Exchange of Net Assets within a Foreign Entity for an Interest in a Joint Venture or Equity Method Investment

Background

Company A (functional U.S. dollar entity) owns a 100% equity interest in Subsidiary X (functional Philippine peso entity) as of December 31, 201X. After year-end, Company A exchanges a group of net assets within Subsidiary X that meets the definition of a business under ASC Topic 805 for an interest in a joint venture or equity method investment for which Company A is one of the owners. Note that Company A retains a 100% equity interest in Subsidiary X after the net asset sale. Additionally, the net assets sold comprise approximately 25% of Subsidiary X's total net assets and therefore the exchange does not constitute a substantial liquidation as contemplated in ASC paragraph 830-30-40-1 (i.e., substantial liquidation generally refers to an amount in excess of 90%). Upon the exchange and corresponding derecognition of the corresponding assets and liabilities sold, Company A recognizes a gain or loss related to the portion of Subsidiary X's total net assets transferred in earnings in accordance with ASC paragraph 810-10-40-5. At the time of the exchange, Company A has a cumulative translation gain of \$1,000,000 within its cumulative translation adjustment account related to Subsidiary X's operations.

Q. How should Company A account for the \$1,000,000 cumulative translation gain within the cumulative translation adjustment account at the time of the exchange of the group of net assets within Subsidiary X for an interest in a joint venture or equity method investment for which Company A is one of the owners?

A. Company A would not release any cumulative translation adjustment into earnings because the sale of net assets within Subsidiary X does not represent a complete or substantially complete liquidation of Subsidiary X.

4.048 Exchange of Investments in Foreign Entities. Entities may enter into transactions to exchange an investment in a consolidated foreign entity or a foreign entity accounted for by the equity method for a controlling or noncontrolling equity interest in another entity. The transaction's specific facts and circumstances must be evaluated to determine whether the cumulative translation adjustment balance attributable to the investment exchanged should be (1) recognized in earnings or (2) transferred from the cumulative translation adjustment account to the noncontrolling interest account at the time of the exchange. The accounting treatment for the cumulative translation adjustment balance depends on many factors, including whether the entity retains a controlling financial interest in the investment exchanged after the transfer. The following scenarios illustrate the accounting for the cumulative translation adjustment balance on the exchange of the investment in the consolidated subsidiary or equity method investment for a controlling or noncontrolling interest in another entity in certain situations. The accounting for other transactions involving the exchange of investments in foreign entities will depend on the facts and circumstances.

- **Exchange of a Consolidated Foreign Subsidiary for a Controlling Financial Interest in an Unrelated Entity.** A parent exchanges its controlling equity interest in a foreign subsidiary for a controlling equity interest in an unrelated entity that conducts either the same or a different line of business and the parent has no direct or indirect ownership in the previously controlled foreign subsidiary after the transfer. Because the parent no longer has a controlling financial interest in the foreign subsidiary, it would deconsolidate the foreign subsidiary in accordance with ASC paragraph 810-10-40-5 and record a gain or loss. Where control of a subsidiary is lost, the parent should recognize the entire balance within its cumulative translation adjustment account related to the foreign subsidiary in earnings at the time of exchange in accordance with ASC paragraph 810-10-40-4A.
- **Exchange of a Consolidated Foreign Subsidiary for a Controlling Financial Interest in the Entity to Which the Foreign Subsidiary Was Transferred.** A parent exchanges its controlling equity interest in a foreign subsidiary for a 60% controlling financial equity interest in the entity to which the foreign subsidiary was transferred. This entity may conduct the same or a different line of business from the parent. Because the parent retained a controlling financial interest in the foreign subsidiary after the exchange, it would account for the exchange as an equity transaction under ASC paragraph 810-10-45-23 and no gain or loss related to the transaction would be recognized in earnings. As discussed in Paragraph 4.039, we believe that a pro rata share of the cumulative translation adjustment attributable to the noncontrolling interest (in this case, 40%) should be transferred from the cumulative translation adjustment account reported in accumulated other comprehensive income to the noncontrolling interest account at the time of the exchange.
- **Exchange of a Consolidated Foreign Subsidiary for a Noncontrolling Financial Interest in the Entity to Which the Foreign Subsidiary Was Transferred.** A parent exchanges its controlling equity interest in a foreign subsidiary for a 40% noncontrolling equity interest in the entity to which the foreign subsidiary was transferred. Because the parent no longer has a controlling financial interest in the foreign subsidiary, it would deconsolidate the foreign subsidiary in accordance with ASC paragraph 810-10-40-5 and record a gain or loss. As discussed in Paragraph 4.040, the entire balance within the parent's cumulative translation adjustment account related to the foreign subsidiary should be recognized in earnings at the time of exchange because the parent no longer has control of the former subsidiary.
- **Exchange of an Equity Method Investment in a Foreign Entity for an Equity Method Investment in an Unrelated Entity.** Assume that a parent exchanges its equity method investment in a foreign entity for a different equity method investment held by an unrelated third party and that the parent will have no continuing involvement or ownership in the investment exchanged. Additionally, all requirements within ASC Topic 860, *Transfers and Servicing*, for sale accounting treatment have been met. Because the

parent has no remaining interest in the equity method investment exchanged, we believe it should recognize the entire balance within its cumulative translation adjustment account related to the equity method investment in earnings at the time of exchange.

Q&A 4.8: Contribution of Foreign Operations to a Consolidated Variable Interest Entity

Background

Company A (functional U.S. dollar entity) owns a 100% equity interest in Subsidiary X (functional Philippine peso entity) as of December 31, 201X. For various business reasons, Company A contributes 100% of the outstanding equity interests in Subsidiary X to a third-party entity (ABC Corp.). After considering the guidance in ASC Subtopic 810-10, Company A determines that ABC Corp. is a variable interest entity and that it is its primary beneficiary (and is therefore be required to consolidate it). Generally, ASC paragraph 810-10-30-1 requires the primary beneficiary of a VIE to measure the assets, liabilities, and noncontrolling interests of the VIE at their fair values on initial consolidation. However, ASC paragraph 810-10-30-3 states that the primary beneficiary should "...measure assets and liabilities that is has transferred to the VIE at, after, or shortly before the date that the reporting entity became the primary beneficiary at the same amounts at which assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of such transfers." After considering this guidance, Company A does not record a gain or loss on the transfer of Subsidiary A to ABC Corp. because it is the primary beneficiary. At the time of the transfer, Company A has a cumulative translation gain of \$1,000,000 within its cumulative translation adjustment account related to Subsidiary X's operations.

Q. How should Company A account for the \$1,000,000 cumulative translation gain within its cumulative translation adjustment account at the time that Subsidiary X is transferred to ABC Corp.?

A. We believe that the entire cumulative translation gain within Company A's cumulative translation adjustment account, even though Company A transferred its 100% equity interest in Subsidiary X, should remain in the cumulative translation adjustment account at the time of the transfer. ASC paragraph 830-30-40-1 states that upon sale or a substantially complete liquidation, the amount remaining within the cumulative translation adjustment account should be recognized as part of the gain or loss recorded for the period in which the sale or liquidation occurs. However, because no gain or loss is being recognized upon the transfer, we believe that it would be inappropriate to recognize the cumulative translation gain within the cumulative translation adjustment account in earnings. Additionally, because Company A retains its controlling financial interest in Subsidiary X, both before and after the transfer, this position is also consistent with ASC paragraph 810-10-45-23, which states that changes in a parent's ownership interest while the parent retains its controlling

financial interest in its subsidiary should be accounted for as an equity transaction with no gain or loss being recognized.

We also believe that Company A should transfer the amount of the cumulative translation adjustment balance attributable to the noncontrolling interest holders from the cumulative translation adjustment account to the noncontrolling interest account at the time of the transfer. Allocating and reclassifying a pro rata share of the cumulative translation adjustment account to the noncontrolling interest account at the time of the sale (i.e., in this case, 100% of the cumulative translation adjustment balance or \$1,000,000) is consistent with the guidance in ASC paragraph 810-10-45-23, which indicates that transactions where the parent retains control are equity in nature (e.g., movement in the cumulative translation adjustment balance should be between equity accounts). Furthermore, the fact that the cumulative translation adjustment balance relates to noncontrolling interests in a VIE does not affect this conclusion. As stated in ASC paragraph 810-10-35-3 “...the assets, liabilities, and noncontrolling interests of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests.”

4.049 Liquidation of a Foreign Entity. The cumulative translation adjustment related to a foreign entity is reclassified from accumulated other comprehensive income and reported as part of gain or loss on liquidation of a foreign entity only when the liquidation of the entity is complete or substantially complete. Liquidation of 90% or more of all assets and liabilities generally would be considered to be a substantially complete liquidation. The following activities generally would not constitute a substantially complete liquidation:

- Payment of annual dividends equivalent to income;
- Payment of liquidating dividends of less than 90% of the net assets; and
- Payment of intercompany balances that had been considered part of the net investment in the foreign entity.

4.049a Pre-sale Restructuring. If a pre-sale restructuring of an entity’s equity interest in the foreign entity (or the net assets held by the foreign entity) does not change the substance of how the foreign entity was managed prior to the restructuring, we do not believe the restructuring impacts the entity’s evaluation of whether a complete sale or a complete or substantially complete liquidation of the foreign entity has occurred.

Example 4.11a: Pre-Sale Restructuring to Facilitate the Future Sale of a Group of Assets

Company A (functional U.S. dollar entity) owns a 100% equity interest in Foreign Subsidiary B (functional currency of Mexican peso). In contemplation of the future sale of 40% of Foreign Subsidiary B’s net assets (Asset Group), the remaining 60% of Foreign Subsidiary B’s net assets are transferred to New Foreign Co., a newly formed

legal entity that is 100% owned by Company A. Prior to the restructuring, Foreign Subsidiary B met the definition of a foreign entity and there were no other distinct and separable operations within Foreign Subsidiary B that would have met the definition of a foreign entity. Two weeks later, Company A sells Asset Group to an unrelated third party.

Given Asset Group represented 40% of the net assets of Foreign Subsidiary B prior to the restructuring, the disposition of Asset Group would not constitute a substantial liquidation of the foreign subsidiary (e.g., the net assets sold would be less than 90% of Foreign Subsidiary B's pre-sale restructuring net assets; see discussion in Paragraph 4.049). The pre-sale restructuring took place to facilitate a future sale and occurred only slightly before closing and does not reflect how Foreign Subsidiary B's operations have been carried out and managed historically. Therefore, the pre-sale restructuring should not redefine Company A's foreign entity determination. The substance of the restructuring and subsequent sale of Asset Group reflects only a partial liquidation of the foreign entity. As such, no cumulative translation adjustment would be released into earnings as part of the restructuring or the subsequent sale.

4.050 Recognition of a pro rata portion of the cumulative translation adjustment in net income is not appropriate for partial *liquidations* of the net assets within a foreign entity. Although the FASB noted in ASC paragraph 830-30-40-3 that partial *liquidations* by a parent of net assets held within a foreign entity may be considered similar to a sale of part of an ownership interest in the foreign entity if the liquidation proceeds are distributed to the parent, the Board concluded that extending pro rata recognition (release of the cumulative translation adjustment into net income) to such partial liquidations would require that their substance be distinguished from ordinary dividends, and that such a distinction is neither possible nor desirable. Therefore, a partial liquidation of the net assets within a foreign entity does not result in the recognition in net income of a pro rata portion of the cumulative translation adjustment.

4.051 A conversion of substantially all of the net assets of a foreign operation to cash, even if the cash was not repatriated, would be a liquidation of a foreign entity requiring recognition in income of the translation adjustment component of accumulated other comprehensive income. The rationale for this conclusion is that the receipt of proceeds from the sale represents receipt of liquidating dividends to the parent accompanied by immediate *reinvestment* of those funds by the parent. The foreign operation ceases to be a distinct and separable operation, as discussed in Paragraphs 2.001-2.003. However, if the *reinvestment* of the funds indicates that the transaction is simply a change in product lines or other activities incident to the evolution of a business, liquidation may not have occurred.

Q&A 4.9: Substantial Liquidation of Foreign Operation

Q. Parent Co. is selling all the operating net assets and ceasing the operations of its foreign Widget subsidiary, whose functional currency is the local currency. The

subsidiary will invest the proceeds of the sale in local currency-denominated certificates of deposit. Parent Co. plans to explore various business interests in the foreign country, outside of the widget industry; however, it presently has no definitive plans for the reinvestment of the funds in specific business operations. Should Parent Co recognize in income the cumulative translation adjustment related to the foreign subsidiary?

A. It is appropriate for Parent Co to recognize the cumulative translation adjustment in income upon the sale of the Widget operations, because the receipt of proceeds from the sale represents, in effect, the receipt of liquidating dividends to Parent Co accompanied by an immediate reinvestment of those funds by the parent.

Q&A 4.10: Cash Dividend to Parent

Q. Would a cash dividend from a foreign subsidiary to its parent trigger partial recognition of the cumulative translation adjustment into income?

A. No. A dividend from a foreign subsidiary to its parent would not trigger partial recognition in income of the cumulative translation adjustment in the absence of ownership loss of controlling interest or a substantially complete liquidation (i.e., liquidation of 90% or more of all assets and liabilities of the subsidiary).

Q&A 4.11: Substantial Liquidation of a Foreign Subsidiary in Multiple Transactions

Q. How should an enterprise assess when a substantially complete liquidation of a foreign subsidiary occurs if the liquidation occurs in more than a single transaction?

A. When an enterprise liquidates part(s) of a subsidiary (less than 90%) and subsequently sells or liquidates an additional part(s) of the subsidiary, the determination of liquidation of 90% or more of all assets and liabilities should be based on the amount of assets and liabilities of the subsidiary at the time when management committed to a substantially complete liquidation of the subsidiary. In determining the assets and liabilities that management committed to sell, the enterprise should consider the criteria in ASC paragraph 360-10-45-9, for an asset group to be classified as held for sale. When the assets and liabilities that meet these criteria comprise more than 90% of the subsidiary, management can be considered to have committed to a substantially complete liquidation. At that time the enterprise also should take into account the cumulative translation adjustment in any evaluation for impairment in accordance with ASC paragraphs 830-30-45-13 through 45-15. If no impairment exists, the enterprise would recognize the cumulative translation adjustment in net income when the substantially complete liquidation is completed.

4.052 Sale or Liquidation of a Second-Tier Foreign Subsidiary or Investee. Judgment is required in assessing whether a sale or liquidation of a foreign entity has occurred upon disposal of a second- or lower-tier foreign subsidiary, particularly a subsidiary or investee of a foreign holding company. For example, a U.S. parent's first-tier subsidiary with a euro functional currency may have a second-tier subsidiary with a euro functional currency. Issues to consider include whether the second-tier subsidiary represents a separate foreign entity (i.e., an operation that is distinct and separable from its parent as discussed in Paragraphs 2.001-2.003 or if it meets the definition of a business as discussed in Paragraphs 4.045-4.047, respectively). If the operation is distinct and separable, the parent should report the cumulative translation adjustment related to the second-tier subsidiary as part of the gain or loss when the subsidiary is sold or liquidated. Besides the criteria discussed in Paragraph 2.003, additional factors to consider in the assessment include:

- Similarities of the business of the disposed subsidiary/investee to those remaining in the foreign holding company; and
- Use of cash received on sale of disposed entity (i.e., was it invested in another subsidiary in substantially the same business in the same country?).

If the operation is not distinct and separable, the cumulative translation adjustment related to the second-tier subsidiary should not be included as part of the gain or loss when the subsidiary is sold or liquidated and instead should remain within the cumulative translation adjustment account at the parent level. See paragraph 4.047 for discussion of the treatment of the cumulative translation adjustment when a parent sells a financial interest in a subsidiary or group of assets within a foreign entity and the subsidiary or group of assets is not a separate foreign entity.

Q&A 4.12: Liquidation of Second-Tier Foreign Investee

Q. Parent Co. has a foreign subsidiary, Subsidiary A, which has a wholly owned subsidiary, Subsidiary B, in the same country as Subsidiary A. The functional currency of both Subsidiary A and Subsidiary B is the foreign currency. Subsidiary B is a sales company for Subsidiary A's products and neither individually meets the definition of a foreign entity. Should Parent Co. recognize the portion of its cumulative translation adjustment that relates to Subsidiary B in income upon Subsidiary A's sale of Subsidiary B?

A. It is not appropriate for Parent Co. to recognize the cumulative translation adjustment in income on the sale of the investment in Subsidiary B by Subsidiary A. Parent Co should consider the combined Subsidiary A and Subsidiary B as the foreign entity, because both companies' operations are integrated. Therefore, this transaction is considered simply a change in the operations of Subsidiary A, as opposed to a substantial liquidation of a foreign entity.

4.053 Spin-Off of a Foreign Entity. A spin-off of a foreign subsidiary or equity investee is a nonreciprocal transfer to owners that under the provisions of ASC paragraph 845-10-30-10 should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the net assets distributed. Accordingly, no gain or loss (other than for impairment, if any) is recognized on a spin-off of a subsidiary or equity investee. Consistent with this guidance, the cumulative translation adjustment should not be recognized in net income but should be reclassified as part of the net adjustment to stockholders' equity. Because a spin-off does not result in reclassification of the cumulative translation adjustment to earnings, it is excluded from the scope of ASC paragraphs 830-30-45-13 through 45-15. Therefore, the cumulative translation adjustment also should not be taken into account in the measurement of impairment loss on disposal.

4.054 Transfer of Foreign Entities between Companies under Common Control. A transfer or exchange of net assets or shares of a foreign subsidiary or investee between companies under common control, is accounted for at carryover basis in accordance with ASC paragraph 805-50-30-5. In these instances, the transfer or exchange does not trigger recognition of the cumulative translation adjustment in earnings. If the foreign subsidiary or investee that has been transferred or exchanged is no longer consolidated by the reporting entity, we believe the cumulative translation adjustment related to that foreign subsidiary or investee should be transferred to additional paid-in capital or retained earnings, which is consistent with the use of carryover basis accounting for the assets being transferred. If the foreign subsidiary or investee that has been transferred or exchanged continues to be consolidated by the reporting entity (e.g., a parent transfers a wholly-owned subsidiary to another wholly owned subsidiary and the consolidated financial statements are being reported on), we believe the cumulative translation adjustment related to that foreign subsidiary or investee should remain in the reporting entity's cumulative translation adjustment.

Q&A 4.13: Sale of Foreign Subsidiary to Parent

Q. Company A, a U.S. company, owns 100% of Company B, a foreign company whose functional currency is the local currency. Company A has a substantial cumulative translation gain in its consolidated financial statements as a result of translating Company B's financial statements into its reporting currency, the U.S. dollar. Company A sells its 100% interest in Company B to its Parent Company and will account for the sale as a capital transaction, because it is between companies under common control. How should Company A account for the cumulative translation adjustment in Company A's stand-alone financial statements?

A. The cumulative translation gain is effectively a component of the historical cost of Company B; consequently, it is eliminated from Company A's stockholders' equity through the recording of the transfer to the Parent Company. If cash were received in excess of Company A's historical cost basis in Company B in connection with the transfer, it should be treated as additional paid-in capital by Company A. This transaction has no effect on Parent Company's consolidated financial statements (i.e., the cumulative

translation adjustment related to Company B would remain in Parent Company's consolidated financial statements).

Q&A 4.14: Merger of Foreign Subsidiaries

Q. Company Z, a U.S. company, has three foreign subsidiaries in the same country whose functional currency is the local currency. Accordingly, Company Z has a cumulative translation adjustment related to translating the financial statements of these three subsidiaries to the reporting currency, the U.S. dollar. Company Z will liquidate two of the three subsidiaries by merging their operations into the third subsidiary. How should Company Z account for the cumulative translation adjustment related to the liquidation of the two subsidiaries?

A. In the consolidated financial statements, Company Z should not recognize the cumulative translation adjustment account related to the two liquidated subsidiaries in income because Company Z's investment in the net assets of these subsidiaries and its exposure to the respective foreign currency risk remains unchanged as a result of this merger/reorganization.

Q&A 4.15: Transfer of Foreign Operations

Q. Company B is a foreign company (local currency is functional currency) that conducts franchising activities in Asia and is a wholly owned subsidiary of Company A (a U.S. Company). Company A intends to liquidate its investment in Company B by transferring Company B's net assets to a domestic subsidiary (Company C) whose functional currency is the U.S. dollar. Company C, going forward, will carry out all franchising activities for Asia. How should Company A account for its cumulative translation adjustment related to Company B?

A. Although Company B will be liquidated upon the transfer of net assets to Company C, the cumulative translation adjustment related to those net assets should not be recognized in net income in the consolidated financial statements of Company A, as those net assets have not been liquidated outside of the consolidated group and the related operations have not ceased. However, Company A should freeze the cumulative translation adjustment at the time of the transfer, in accordance with ASC paragraph 830-10-45-10, as the functional currency of the entity now holding those assets is the U.S. dollar.

REMEASUREMENT OF THE BOOKS OF RECORD INTO THE FUNCTIONAL CURRENCY

4.055 If an entity maintains its accounting records in a currency other than the functional currency, they must be converted into the functional currency by a process called remeasurement. The remeasurement process is intended to produce the same accounting result as if the entity's books of record had been maintained in the functional currency. Consequently, historical exchange rates are used for nonmonetary assets, liabilities, and related income and expenses denominated in a currency other than the functional currency, and current exchange rates are used to remeasure monetary assets, liabilities, and related income and expenses. Exchange gains and losses that arise from the remeasurement process are reported in determining net income. ASC paragraphs 830-10-45-17, 830-20-25-2

4.056 Technically the remeasurement of books of record into an entity's functional currency is not a translation of foreign currency financial statements as that term is used in ASC Topic 830, even if it is done solely for consolidation purposes. It represents retroactive application of recognition and measurement principles for foreign currency transactions as discussed in Section 3, *Foreign Currency Transactions*. Therefore, the guidance in Section 3 applies to the remeasurement of books of record into an entity's functional currency. If the entity's functional currency is the reporting currency of the enterprise, remeasurement obviates translation. If the entity's functional currency is different from the enterprise's reporting currency, remeasurement into the entity's functional currency is followed by translation into the reporting currency, as discussed in this Section. ASC paragraphs 830-10-45-17, 830-20-25-2

ENTITIES IN HIGHLY INFLATIONARY ECONOMIES

4.057 The same principles (i.e., application of recognition and measurement principles for foreign currency transactions), apply to the remeasurement of the financial statements of a foreign entity in a highly inflationary economy into the reporting currency as if it were the entity's functional currency. Therefore, the guidance in Section 3 also applies to this remeasurement. Several specific circumstances that may be encountered in these situations are discussed below. ASC paragraph 830-10-45-11, Statement 52, par. 107

Example 4.12: Remeasurement

Company M is a subsidiary of A Corp., a U.S. company, and is located in a highly inflationary economy. Company M's books are maintained in local currency (LC) and must be remeasured as if its functional currency (FC) were the U.S. dollar (US\$). At the balance sheet date (1 LC = \$.0003), Company M's books of record include receivables denominated in a variety of currencies, as follows:

4. Translation of Foreign Currency Financial Statements

LC	10,000,000
US\$	1,000,000
euros	800,000

Remeasurement of Company M's receivables under ASC Topic 830 would result in the following balance of accounts receivable included in the U.S. consolidation:

	Receivables	Current Exchange Rate Into US\$	Parent's FC Amount
LC	10,000,000	.0003	\$3,000
US\$	\$1,000,000	n/a ^a	1,000,000
euros	800,000	.9 ^b	720,000
			<u>\$1,723,000</u>

^a Remeasurement is not required because the receivable is denominated in the parent's FC (US\$).

^b Remeasurement is made directly from euros into the parent's FC (US\$).

As the parent's currency is treated as if it were the entity's functional currency, no further translation is necessary.

4.058 Monetary Items in Highly Inflationary Economies. Noninterest-bearing short-term receivables and payables denominated in the currency of a highly inflationary economy may require thorough evaluation before remeasurement into the functional currency. In highly inflationary economies, those receivables and payables frequently are indexed for inflation. If not, the face amount of the receivable or payable may include a component to compensate for inflation. ASC Subtopics 835-30, *Interest - Imputation of Interest*, and 310-10, *Receivables - Overall*, provide guidance for the appropriate accounting when the face amount of a receivable or payable does not reasonably represent the present value of the consideration given or received in the exchange. According to ASC paragraph 835-30-15-3, this guidance is not intended to apply to receivables and payables with terms not exceeding approximately one year. However, this guidance was written with a view of the U.S. economic environment. In highly inflationary economies, the application of the principles of ASC Subtopic 835-30 to short-term receivables and payables may be warranted to properly reflect the value of the consideration given or received in a transaction.

Q&A 4.16: Dividend Payable to Noncontrolling Interest

Q. Company A's majority-owned foreign subsidiary, which operates in a highly inflationary economy, declared a dividend and recorded a respective dividend payable in its local currency. In consolidation, Company A's portion of the dividend was eliminated and the noncontrolling interest holders' portion was classified in noncontrolling interest.

How should Company A record the exchange gain on the dividend payable to the noncontrolling interest holders' due to devaluation of the foreign currency?

A. Company A should allocate the exchange gain on the dividend payable to the noncontrolling interest holders to noncontrolling interest because the unpaid dividends effectively represent additional investments of the shareholders, and related gains should be allocated proportionately.

4.059 Change from a Non-Highly Inflationary to a Highly Inflationary Economy.

ASC paragraphs 830-10-45-10 through 45-14 address the accounting consequences when the determination is made that an economy is highly inflationary.

4.060 The FASB staff believes that the guidance for a change in functional currency from the foreign currency to the reporting currency due to significant changes in economic facts and circumstances, as discussed in Paragraph 4.023, also should be used to account for a change in functional currency from the foreign currency to the reporting currency when an economy becomes highly inflationary, although that guidance was not originally developed to address high-inflation situations. That is, cumulative translation adjustments for prior periods should not be removed from equity and the translated amounts for nonmonetary assets and liabilities at the end of the prior period become the accounting basis for those assets and liabilities in the period of the change and subsequent periods. ASC paragraph 830-10-45-10

4.061 Additionally, ASC paragraph 830-10-45-16 addresses the accounting consequences for deferred taxes when the functional currency changes from the foreign currency to the reporting currency. See Paragraphs 7.049 and 7.050 (Section 7, Foreign Operations) of KPMG Handbook, [Accounting for Income Taxes](#), for a discussion of this issue.

4.062 Accounting for a Dollar Distortion on Changing to a Highly Inflationary Economy. There may be circumstances where reported balances of monetary assets or liabilities for financial reporting purposes differ from the actual U.S. dollar denominated balances held by a foreign subsidiary because different rates were used for remeasurement and translation purposes (See Example 7.2 for an illustration of a dollar distortion resulting from the use of different exchange rates for remeasurement and translation purposes). A question arises as to the accounting for dollar distortion balances before and after the transition of a foreign subsidiary to highly inflationary status, at which point the functional currency of the foreign subsidiary would be the parent's reporting currency. The SEC staff indicated in ASC paragraph 830-30-S99-1 that differences between the amounts reported for financial reporting purposes and actual U.S. dollar denominated balances that may have existed before the transition to highly inflationary status should be recognized in earnings, unless an entity can document that the difference was previously recognized as an adjustment to the cumulative translation adjustment balance. The difference should be recognized upon the transition to highly inflationary status. In these cases, the amount that will be recognized through the income statement (as well as the effect on the other financial statements) should be disclosed before the transition to highly inflationary status.

4.063 We understand that there would be very limited circumstances in which the difference would be recognized as a translation adjustment under this guidance. We believe that one circumstance in which an entity would be able to document that this difference was previously recognized as a translation adjustment is when the difference relates solely to an entity's change in the exchange rate used for translation purposes in the period before transitioning to highly inflationary status. For example, if historically an entity had used the same exchange rate for both remeasurement and translation purposes, but determined before transition to highly inflationary status that it was appropriate to remeasure at a preference rate and translate using a penalty rate, the difference between the amount reported for financial reporting purposes and the actual U.S. dollar denominated balance would have been recognized as a translation adjustment, because the change relates solely to the change in the rate used for translation purposes. In this circumstance, upon the transition to highly inflationary status, we believe that the entity would be able to document that the difference was previously recognized as a translation adjustment; consequently, the dollar distortion should be recognized as an adjustment to the cumulative translation adjustment balance.

4.064 Change from a Highly Inflationary to a Non-Highly Inflationary Economy.

The appropriate accounting for a change from a highly inflationary to a non-highly inflationary economy would be a prospective measurement in the new functional currency. ASC paragraphs 830-10-45-15 and 830-10-55-13 and 55-14, require a foreign entity's nonmonetary assets and liabilities that were remeasured in the reporting currency (as if it were the functional currency) to be translated into the foreign currency at current exchange rates as of the date of the change from highly inflationary to non-highly inflationary. These restated amounts become the functional currency accounting basis of the nonmonetary assets and liabilities for consolidation purposes.

4.065 The accounting described in Paragraph 4.064 is different from the accounting for a change in functional currency from the reporting currency to the foreign currency in a non-highly inflationary environment as discussed in Paragraph 4.025, where the historical foreign currency accounting basis for nonmonetary assets and liabilities becomes the functional currency accounting basis. Returning to the historical foreign currency accounting basis in an economy that was highly inflationary would mean returning to an accounting basis considered to have lost its relevance for financial reporting purposes in the first place (the disappearing asset). The current foreign currency equivalent of historical cost measured in a more stable currency provides a more relevant accounting basis.

4.066 Example 4.13 describes an application of the guidance within ASC paragraphs 830-10-45-15 and 830-10-55-13 and 55-14.

Example 4.13: Change from a Highly Inflationary to a Non-Highly Inflationary Economy

A foreign subsidiary of a U.S. entity that operates in a highly inflationary economy purchased equipment with a 10-year useful life for 100,000 local currency (LC) on

January 1, 19X1. The exchange rate on the purchase date was 10LC to 1US\$, so the U.S. dollar equivalent cost was \$10,000. On December 31, 19X5, the equipment has a net book value on the subsidiary's local books of LC50,000 (original cost of LC100,000 less accumulated depreciation of LC50,000) and the current exchange rate is 75LC to the US\$. In the U.S. parent's financial statements, annual depreciation expense of \$1,000 has been reported for each of the past five years, and at December 31, 19X5, the equipment is reported at \$5,000 (foreign currency basis measured at the historical exchange rate). As of the beginning of 19X6, the economy of the subsidiary ceases to be considered highly inflationary. Under the guidance in ASC paragraph 830-10-45-15, a new functional currency accounting basis for the equipment would be established as of January 1, 19X6. The new functional currency basis would be determined by translating the reporting currency amount of \$5,000 into the functional currency at the current exchange rate of 75LC to the US\$. The new functional currency accounting basis at the date of change would be LC375,000. For U.S. reporting purposes, the new functional currency accounting basis and related depreciation subsequently would be translated into U.S. dollars at current and average exchange rates, respectively.

4.067 As a result of applying the guidance in ASC paragraph 830-10-45-15, the functional currency bases generally will be different from the local currency tax bases of nonmonetary assets and liabilities. The deferred tax accounting consequences of these differences are discussed in Paragraphs 7.051 and 7.052 (Section 7, Foreign Operations) of KPMG Handbook, [Accounting for Income Taxes](#).

CONSOLIDATION ELIMINATION

4.068 Elimination of Intercompany Profit. Intercompany sales or transfers frequently produce intercompany profits for the selling entity and, likewise, the acquiring entity's cost includes a component of intercompany profit. The intercompany profit included in the carrying amount of assets as of the balance sheet date should be eliminated based on exchange rates in effect on the date of the intercompany sale or transfer; in accordance with ASC paragraph 830-10-55-10, the use of averages or other methods of approximation is acceptable. Thus, subsequent changes in the exchange rate should not affect that intercompany profit. Statement 52, pars. 136-137

Example 4.14: Elimination of Intercompany Profits on Inventory

Assume the following:

- Foreign Company A, a subsidiary of Company B, a U.S. parent, has its local currency (LC) as its functional currency (FC).
- On November 1, 20X2, US\$1 was equivalent to LC0.5.

- At that date goods, which had cost US\$30, were sold by Company B to Company A for US\$40.
- Company A recorded the goods at LC20.
- On December 31, 20X2, US\$1 was equivalent to LC0.625.

The LC20 inventory has two components:

- Cost component: LC15 ($\$30 \times 0.5$); and
- Intercompany profit: LC5.

The LC5 intercompany profit component should be translated at the historical ($\$1 = \text{LC}0.5$) rate. The \$10 result is the same as the profit originally recorded by Company B. These two balances are eliminated in consolidation. The LC15 cost component should be translated at the current rate at the balance sheet date ($\$1 = \text{LC}0.625$), which results in \$24 as the value of the inventory in the consolidated balance sheet.

4.069 Unsettled Intercompany Transactions Remeasured Using Preference or Penalty Rates. As discussed in Paragraph 4.007, in the absence of unusual circumstances, the dividend remittance exchange rate should be used to translate foreign currency financial statements. However, as noted in ASC paragraph 830-30-45-7, translation of foreign currency financial statements at the dividend remittance rate may cause a difference between intercompany receivables and payables when unsettled intercompany transactions are subject to and remeasured into the functional currency using preference or penalty exchange rates. In this situation, until the difference is eliminated by settling the intercompany transaction, the enterprise should treat the difference as a receivable or payable in its consolidated financial statements.

Example 4.15: Unsettled Intercompany Transaction Remeasured Using Penalty Rate

A U.S. company sells equipment for US\$1,000 to its foreign subsidiary whose functional currency is the local currency (LC). A penalty rate of $\text{US}\$1 = \text{LC}12$ applies to imports of the equipment in the foreign country, whereas the general rate of $\text{US}\$1 = \text{LC}10$ applies to dividend remittances. If the purchase price is unsettled at the balance sheet date, the subsidiary's functional currency payable of LC12,000 is translated into US\$1,200. In consolidation, this intercompany payable and the parent's respective intercompany receivable are eliminated, and the difference of US\$200 is shown as a payable in the consolidated financial statements until the transaction is settled.

4.070 Intercompany Transactions Denominated in a Foreign Currency. It is important to note that intercompany transactions denominated in a foreign currency are remeasured into the functional currency at current exchange rates and give rise to gains or losses when the exchange rates fluctuate. These gains or losses are not eliminated in

consolidation. See Paragraph 4.017 for further discussion. Companies may consider hedging this risk. See discussion in Section 5.

Example 4.16: Intercompany Transaction Denominated in a Foreign Currency

Company A (a US\$ functional/reporting entity) sells equipment for US\$1,000 to its foreign subsidiary whose functional currency is the local currency (LC). The current exchange rate is US\$1 = LC9. The \$1,000 intercompany payable at quarter-end is remeasured to LC by the subsidiary. The quarter-end current rate is US\$1 = LC12. The remeasurement of the subsidiary's foreign currency payable of US\$1,000 generates a loss of LC3,000 in net income of the subsidiary, which is translated to US\$ using average rates. This loss is not eliminated in consolidation; and thus is reflected in the consolidated results of operations of Company A.

4.071 Intercompany Dividends. The declaration or payment of dividends by a foreign entity that is consolidated or accounted for by the equity method to its investor does not result in transaction gains or losses. The declaration or payment of a dividend, like any other equity transaction, is translated at the historical exchange rate (i.e., the transaction date exchange rate). Cumulative translation adjustments related to retained earnings of a foreign entity should not be recognized in net income upon declaration or payment of dividends, but only upon partial or complete sale or upon complete or substantially complete liquidation of the foreign entity. Changes in the exchange rate between the last balance sheet date and the date of declaration of a dividend should be reported as translation adjustments in other comprehensive income. However, transaction gains or losses may arise during the period between declaration and payment of dividends, as discussed in Paragraph 3.065. ASC paragraphs 830-30-40-1, 830-30-45-12

4.072 Net Investment in a Foreign Operation. One of the premises of ASC paragraph 830-20-35-3 is that exchange rate changes that affect an investor's net investment in a foreign operation should be reported as a translation adjustment in other comprehensive income. The critical question is what constitutes the investor's net investment.

An investor's net investment may include:

- The net investment in a foreign operation; and
- Intercompany foreign-currency-denominated transactions that are of a long-term investment nature with that foreign operation.

ASC paragraph 830-20-35-3(b) requires gains and losses resulting from intercompany foreign currency transactions that are of a long-term investment nature to be reported in other comprehensive income instead of in current earnings when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements. As a result, to determine its net investment in a

foreign operation for hedge accounting purposes, we believe an entity can either include or exclude the effects of any intercompany foreign-currency denominated transactions of a long-term investment nature with that foreign operation (e.g., adding an intercompany foreign-currency-denominated receivable of a long-term investment nature or subtracting an intercompany foreign-currency-denominated payable of a long-term investment nature). ASC subparagraph 830-20-35-3(b)

4.073 Intercompany Transactions of a Long-Term Investment Nature. Whether an investment is considered of a long-term investment nature depends on whether its settlement is planned or anticipated in the foreseeable future. ASC Topic 830 provides no definition of the foreseeable future, so judgment is required to determine whether an intercompany foreign currency transaction is of a long-term investment nature. An intercompany transaction could be determined to be of a long-term investment nature even if it takes the form of an advance or demand note payable, provided that payment is not planned or anticipated in the foreseeable future. Foreseeable future does not imply a specific time period (i.e., 20 years or 50 years). Whether repayment is presently planned or anticipated is the key factor. Management intent is paramount in determining whether a particular intercompany balance is of a long-term investment nature. Therefore, management should document its intent with respect to settling significant intercompany transactions and balances that are considered to be of a long-term investment nature. Transaction gains and losses attributable to other intercompany transactions and balances, however, affect functional currency cash flows; therefore, increases or decreases in actual and expected functional currency cash flows due to changes in currency exchange rates should be included in determining net income. ASC subparagraph 830-20-35-3(b), ASC paragraph 830-30-45-12

4.074 Management's intent about settlement must be supported by the ability to control whether repayment will be made. For example, Company A transfers U.S. \$10 million to a foreign subsidiary to facilitate a potential business acquisition in the local country. If the acquisition does not occur, Company A will require the U.S. \$10 million to be repaid, because the foreign subsidiary would not have a valid business need for these funds. Company A would not conclude that the advance is of a long-term investment nature until the business acquisition takes place. Another example where management's intent about settlement would not be supported by the ability to control whether repayment will be made is when the parent advances funds to a limited-life foreign subsidiary. Because the subsidiary's life is limited, repayment of the advance is not under management's control.

4.075 Paragraph 3.010 discusses the effect of interest payments on intercompany transactions considered to be of a long-term investment nature.

Q&A 4.17: Loan from Subsidiary to Parent

Q. Parent, a U.S. company, has a U.S. dollar-denominated loan payable to its wholly owned foreign Subsidiary whose functional currency is the local currency. Parent is not required to and does not plan to repay the loan in the foreseeable future. May the

transaction gain or loss recorded by Subsidiary on its U.S. dollar-denominated loan receivable in its functional currency financial statements be reclassified as a translation adjustment in Parent's consolidated financial statements?

A. Yes. A loan payable to a subsidiary that the parent does not intend to repay is similar to a capital distribution by the subsidiary, which reduces Parent's net investment in Subsidiary. This conclusion applies as long as Parent's net investment (i.e., equity investment less loan payable), is zero or greater.

Q&A 4.18: Loan to Indirect Subsidiary

Q. Parent and its wholly owned Subsidiary A have the U.S. dollar as their functional currency. Subsidiary A's wholly owned foreign Subsidiary B has the local currency as its functional currency. Subsidiary B has a U.S. dollar-denominated loan payable to Parent that is not anticipated to be repaid in the foreseeable future. May the transaction gain or loss recorded by Subsidiary B on its U.S. dollar-denominated loan payable to Parent in its functional currency financial statements be reclassified as a translation adjustment in (1) Parent's consolidated financial statements, and (2) Subsidiary A's consolidated financial statements?

A. (1) Yes. Parent may reclassify the transaction gain or loss as a translation adjustment in its consolidated financial statements, as both parties to the transaction are included in Parent's consolidated financial statements and the loan can be considered to be part of Parent's net investment in Subsidiary B.

(2) No. The transaction gain or loss may not be reclassified as a translation adjustment in Subsidiary A's consolidated financial statements, as Subsidiary B's loan payable is to an entity outside of Subsidiary A's consolidated group and, therefore, cannot be considered part of a consolidated entity's net investment in Subsidiary B. Further, Subsidiary A's management is in no position to control or represent that settlement is not planned or anticipated in the foreseeable future.

Q&A 4.19: Loan Between Sister Companies

Q. Parent, a U.S. company whose functional currency is the U.S. dollar, has two wholly owned subsidiaries, Subsidiary A whose functional currency is the euro, and Subsidiary B whose functional currency is the pound sterling. Subsidiary B grants a loan denominated in its functional currency to Subsidiary A. Parent and Subsidiary B do not plan to require Subsidiary A to repay the loan in the foreseeable future. How should Parent recognize transaction gains or losses recorded by Subsidiary A in respect of the loan in Parent's consolidated financial statements?

A. Parent should recognize any exchange difference in respect of the loan as a translation adjustment in other comprehensive income within its consolidated financial statements because, from the point of view of Parent's consolidated financial statements, the funding relates to an investment in a foreign operation.

Example 4.17: Inclusion of Intercompany Foreign-Currency Denominated Transaction in a Net Investment Hedge

Parent, a U.S. Company whose functional currency is the U.S. dollar, has a wholly owned foreign subsidiary whose functional currency is the Japanese yen. Parent has a Japanese yen-denominated intercompany receivable from subsidiary that is considered to be of a long-term nature (i.e., not anticipated to be repaid in the foreseeable future). The intercompany foreign-currency-denominated receivable may be included in Parent's net investment for purposes of hedge accounting because it is of a long-term nature.

However, if the intercompany receivable comprises individual amounts that are repaid and reloaned on a recurring basis, it may not be included in Parent's net investment for purposes of hedge accounting as it is not of a long-term nature.

4.076 Aggregation of Intercompany Transactions. Determining the nature of the intercompany transaction should be based on individual receivables or payables and not on a group of receivables or payables. A group view would hold that, even though the individual receivable and payable is being settled, maintenance of a constant level (minimum balance) permits a group of transactions that are part of the minimum balance to be considered a long-term investment item. That view is not the approach contemplated in ASC Topic 830.

4.077 Parent Guarantee of Investee Debt. A parent company's guarantee to contribute equity or to lend on a long-term basis the funds needed by the investee to repay a third-party lender at maturity of a loan does not qualify for the application of ASC subparagraph 830-20-35-3(b) to the investee's borrowing. A transaction in which a parent company merely guarantees a subsidiary's debt is not considered an intercompany transaction of a long-term investment nature.

4.078 Settlement of Intercompany Balances of a Long-Term Investment Nature. An intercompany balance may have been appropriately considered to be of a long-term investment nature and, accordingly, transaction gains and losses have been reclassified and reported in the same manner as translation adjustments in the consolidated financial statements. Nevertheless, at some time the decision may be made to settle the intercompany transaction. We believe that the decision to settle the intercompany transaction changes the nature of the transaction. Therefore, the transaction gains and losses that occur after the decision to settle the transaction should be included in determining net income. The cumulative transaction gain or loss previously reported in

the same manner as a translation adjustment in accumulated other comprehensive income should remain in this account until partial or complete sale or complete or substantially complete liquidation of the investment in the foreign entity.

4.079 Forgiveness of Intercompany Balances of a Long-Term Investment Nature.

The decision to forgive an intercompany balance of a long-term investment nature is different from the decision to settle it because forgiveness will not result in cash flows. Forgiveness further supports the premise that the transaction was intended to be viewed as an increase or decrease in the net investment in a foreign entity. Therefore, transaction gains or losses attributable to the intercompany balance that occur after the decision to forgive the balance should continue to be included in accumulated other comprehensive income in the consolidated financial statements.

4.080 Presentation in Separate Financial Statements. Foreign currency gains and losses on intercompany transactions of a long-term investment nature are reported as a translation adjustment in other comprehensive income in the consolidated financial statements. However, this accounting is not appropriate for separate company financial statements of a subsidiary. A subsidiary with an intercompany payable intended by the parent to be a long-term investment in the subsidiary should include transaction gains or losses related to the intercompany payable in income if the subsidiary's separate financial statements are intended to be in accordance with U.S. generally accepted accounting principles. However, in separate financial statements or summary financial information intended to be only a disaggregation of information in the consolidated statements, those items may be treated in a manner consistent with their treatment in the consolidated statements.

Section 5 - Foreign Currency Derivatives and Hedging Foreign Currency Risk

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Hedge of Foreign Currency Exposure of a Net Investment in a Foreign Operation

Q&A 5.7: Net Investment Hedge

5.000 This section of the guide summarizes the provisions of ASC Topic 815, *Derivatives and Hedging*, that address foreign currency risk. The first part of the section provides an overview of the accounting for foreign currency derivative instruments. The remainder, beginning with Paragraph 5.018, discusses the concept of hedging foreign currency exposure, the types of foreign currency hedges, and the hedging items/instruments that are used in a foreign currency hedging relationship. For more detailed guidance related to these issues, see KPMG Handbook, [Derivatives and hedging](#).

FOREIGN CURRENCY DERIVATIVE INSTRUMENTS

5.001 Foreign currency transactions generally are subject to the provisions of ASC Topic 830, *Foreign Currency Matters*. However, foreign currency derivatives and other derivative instruments are subject to ASC Topic 815. It is important to note that, even if foreign currency derivatives are considered foreign currency transactions, the measurement of those instruments is at fair value under ASC Topic 815 rather than at current exchange rates under ASC Topic 830.

5.002 Definition. ASC paragraph 815-10-15-83 defines a derivative instrument as a financial instrument or other contract that has the following characteristics:

- a. It has (1) one or more underlyings and (2) one or more notional amounts, or payment provisions, or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether settlement is required.
- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Its terms implicitly or explicitly require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

5.003 Derivative instruments include contracts that (a) in their entirety meet the definition of a derivative instrument (so-called freestanding derivative instruments) and (b) are contained in contracts that do not in their entirety meet the definition of a derivative instrument but that contain implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument (i.e., *embedded* derivative instruments).

5.004 Freestanding Foreign Currency Derivative Instruments. The most common types of freestanding foreign currency derivative instruments include:

- **Forward foreign exchange contracts.** Contracts to pay or receive specific amounts of currency at a future date in exchange for another currency at an agreed-upon currency exchange rate.

5. Foreign Currency Derivatives and Hedging Foreign Currency Risk

- **Currency futures.** Contracts that require the delivery of a fixed amount of foreign currency at a future date in exchange for another currency at an agreed-upon currency exchange rate. Unlike forward foreign exchange contracts, futures are standardized and are traded on an organized exchange. The exchange acts as the intermediary in the processing and settlement of these contracts and requires the participants to maintain a valuation margin deposit (a portion of the total contract value adjusted daily by the market change of the contract), which is designed to limit the counterparty credit exposure as currency exchange rates change.
- **Currency swaps.** The two most common types of currency swaps are traditional fixed/fixed currency swaps and cross-currency swaps. In a traditional fixed/fixed currency swap, the counterparties agree to exchange principal and fixed interest payments denominated in different currencies based on an agreed-upon currency exchange rate. Cross-currency swaps involve the exchange of floating interest rate payments in one currency for fixed or floating interest rate payments in another currency. Thus, a traditional fixed/fixed currency swap uses two fixed rates and its value is affected by currency exchange rates and indirectly by interest rates, while a cross-currency swap use one fixed rate and one floating rate, or two floating rates, which are based on different notional amounts, in terms of currency and magnitude, and its value is directly affected by both currency exchange rates and interest rates.
- **Currency options.** The buyer of a currency option pays a premium to receive the right to purchase (a call option) or sell (a put option) a specified quantity of a specified currency at a specified currency exchange rate within (American option) or at the end of (European option) the exercise period. The principal difference between an option and a futures or forward contract is that the exercise of an option by the holder is optional, but the exercise of a futures or forward contract is mandatory.

5.005 Even though the contracts described in Paragraph 5.004 are the types of foreign currency derivative instruments generally encountered in practice, other types of contracts involving foreign currency(ies) also may meet the definition of a derivative instrument, as defined ASC paragraph 815-10-15-83 and Paragraph 5.002.

5.006 Section 3 of KPMG Handbook, [Derivatives and hedging](#), provides a detailed description on the characteristics of derivative instruments and how to determine whether a financial instrument or other contract meets the definition of a derivative instrument.

5.007 Accounting for Freestanding Derivative Instruments. ASC paragraphs 815-10-25-1, 815-10-30-1, and 815-10-35-1 require all derivative instruments to be recognized as either assets or liabilities in the balance sheet, and measured at fair value each reporting period. The accounting for changes in the fair value (i.e., gains and losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. The gain or loss on a derivative instrument that is not designated as a hedging instrument should be recognized in net income.

5.008 Embedded Foreign Currency Derivative Instruments. ASC Topic 815 also applies to certain components of nonderivative instruments and contracts that contain terms that behave similarly to derivative instruments. These nonderivative instruments and contracts, referred to as hybrid instruments, often contain embedded derivatives. The effect of embedding a derivative instrument in a nonderivative contract (the *host contract*) is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent on the occurrence of a specified event, will be modified based on one or more underlyings.

5.009 Accounting for an Embedded Derivative Instrument. ASC paragraph 815-15-25-1 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument under ASC Subtopic 815-10 *Derivatives and Hedging - Overall*, if, and only if, all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The contract (the *hybrid instrument*) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles, with changes in fair value reported in net income as they occur.
- c. A separate instrument with the same terms as the embedded derivative instrument would, under ASC Section 815-10-15, be a derivative instrument subject to the requirements of ASC Subtopic 815-10. (The initial net investment for the hybrid instrument should not be considered to be the initial net investment for the embedded derivative.)

5.010 ASC paragraph 815-15-15-10 provides an exclusion from the separation requirements of ASC paragraph 815-15-25-1 for certain embedded foreign currency derivative instruments. An embedded foreign currency derivative instrument should not be separated from the host contract and considered a derivative instrument under ASC paragraph 815-15-25-1 if the host contract is not a financial instrument and it requires payment(s) denominated in any of the following currencies: (a) the currency of the primary economic environment in which any substantial party to that contract operates (i.e., its functional currency), (b) the local currency of any substantial party to that contract, (c) the currency used by a substantial party to that contract as if it were the functional currency because the primary economic environment in which that party operates is highly inflationary (as discussed in ASC paragraph 830-10-45-11), or (d) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (e.g., the U.S. dollar for crude oil transactions).

5.011 Also, ASC paragraph 815-15-15-5 states that unsettled foreign currency transactions, including financial instruments, that are (a) monetary items, (b) have their principal payments, interest payments, or both denominated in a foreign currency, and (c) are subject to the requirement in ASC paragraph 830-20-35-1 to recognize any foreign

currency transaction gain or loss in net income, should not be considered to contain embedded foreign currency derivative instruments under ASC Topic 815. The same proscription applies to available-for-sale or trading debt securities that have cash flows denominated in a foreign currency.

5.012 Section 4 of KPMG Handbook, [Derivatives and hedging](#), provides detailed guidance about whether an embedded derivative instrument should be separated from the host contract and considered a derivative instrument. The guidance in that section also applies to foreign currency-embedded derivative instruments. See Question 2.2.10 of KPMG Handbook, [Leases](#), for guidance specific to operating leases with an embedded foreign exchange component.

5.012a Embedded derivative instruments that are separated from their host contract should be accounted for in the same manner as a freestanding derivative instrument would be accounted for under ASC Topic 815; that is, they should be measured at fair value and the accounting for changes in their fair value (i.e., gains or losses) depends on whether the derivative has been designated and qualifies as part of a hedging relationship. The gain or loss on an embedded foreign currency derivative instrument that is not designated as a hedging instrument should be recognized in net income. The host contract from which the embedded derivative instrument has been separated should be accounted for under generally accepted accounting principles that apply to the host.

5.013 For certain limited circumstances, ASC paragraph 815-15-25-53 prescribes the accounting when an entity cannot reliably identify and measure an embedded derivative component apart from the host contract. If an entity cannot reliably identify and measure the embedded derivative component for separation from the host contract, the entity should measure the entire contract, including both the derivative and nonderivative portions, at fair value, with changes in fair value reported in net income. However, the instrument cannot be used as a hedging instrument.

5.014 Entities entering into sophisticated investment and funding strategies, such as structured notes or other compound contracts with embedded derivative components, will generally be able to obtain the information necessary to identify and measure the separate components. Accordingly, we believe it would be unusual for an entity to conclude that it cannot separate an embedded derivative component from its host contract in a reliable manner.

5.015 Presentation of Embedded Foreign Currency Derivative Instruments. When an embedded foreign currency derivative instrument is required to be separated from its host contract and accounted for as a derivative instrument, an issue arises as to whether the embedded derivative instrument should be presented separately from the host contract on the balance sheet. We believe either of the following approaches is acceptable as an accounting policy election.

- **Present the embedded derivative instrument together with the host contract** – i.e., following the legal form of the instrument. In this situation, the carrying amount of the hybrid instrument will reflect the aggregate

carrying amount of the host contract and the fair value of the embedded derivative instrument. We believe this presentation is only acceptable when the host contract is classified as an asset or liability (and not when it is classified in equity or temporary equity) because an embedded derivative must be accounted for as an asset or liability (see section 5.5.10 of KPMG Handbook, [Derivatives and hedging](#)).

- **Present the embedded derivative instrument separately from the host contract.** We believe this is an acceptable presentation regardless of how the host contract is classified.

In our experience, most entities present the embedded instrument together with the host contract when that is acceptable. Regardless of the presentation alternative chosen, an entity should consistently apply its policy and disclose it.

5.016 Determining Fair Value. Providing guidance for determining the fair value of a derivative instrument (either freestanding or embedded) generally is beyond the scope of this guide. However, ASC paragraph 820-10-35-2 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In addition to defining fair value, ASC Topic 820, *Fair Value Measurement*, provides a framework for measuring fair value, which refers to certain valuation concepts and practices, and requires certain disclosures about fair value measurements.

5.017 ASC paragraphs 815-10-30-1 and 815-10-35-1 require the guidance in ASC Subtopic 825-10, *Financial Instruments - Overall*, and ASC Topic 820 to be applied to determine the fair value of a derivative instrument. ASC paragraph 825-10-50-10 requires disclosure of fair value of financial instruments either in the body of the financial statements or in the accompanying notes. ASC Topic 815 requires entities to determine the fair value of derivative instruments in all circumstances. In the absence of quoted market prices or current market transactions for contracts with similar items, an entity might be required to use valuation techniques that are in accordance with ASC Topic 820 to determine the fair value of a specific foreign currency derivative instrument.

HEDGING FOREIGN CURRENCY EXPOSURE

5.018 The Concept of Hedging Foreign Currency Exposure. The accounting for hedges of foreign currency exposure requires an understanding of the underlying functional currency concept, which determines when, for accounting purposes, a foreign currency exposure exists. Consistent with ASC Topic 830 and ASC paragraph 815-20-25-23, a foreign currency exposure exists only in relation to a specific operating unit's designated functional currency cash flows and therefore exposure to foreign currency risk should be assessed at the unit level. Consistent with ASC paragraph 815-20-25-24, a unit has exposure to foreign currency risk when a transaction, asset, or liability, or net investment in a foreign operation of the unit is denominated in a currency other than that unit's functional currency. For example, if an entity's functional currency is the U.S. dollar, a foreign currency exposure exists only where transactions, assets, or liabilities, or

a net investment in a foreign operation are denominated in a currency other than the U.S. dollar.

5.019 ASC paragraph 815-20-25-28 identifies the following foreign currency exposures that can be hedged for accounting purposes:

- Fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale-debt security).
- Cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intra-entity transaction.
- Hedge of a net investment in a foreign operation.

5.020 Even though the hedging models for foreign currency exposures generally are consistent with those used for hedges of other fair value and cash flow exposures, there are some differences. These differences relate to hedges of net investments in foreign operations and to the use of nonderivative instruments as the hedging instruments.

5.021 Hedging a Net Investment in a Foreign Operation. Under ASC Subtopic 815-20, *Derivatives and Hedging - Hedging - General*, hedging a net investment in a foreign operation is the same as designating a group of dissimilar assets and liabilities as a hedged item (i.e., the net investment is the aggregation of dissimilar assets and liabilities of the investee), which is not permitted for a fair value or cash flow hedge under ASC Topic 815. However, before the issuance of ASC Topic 815, ASC Topic 830 permitted hedge accounting of net investments in a foreign operation and practice in this area was well established. Because the Board did not comprehensively reconsider the accounting provisions of ASC Topic 830, the FASB decided to continue to permit hedging a net investment in a foreign operation. Thus, although the Board was seeking consistency, it decided to accept this difference between the hedge accounting models applied to foreign currency exposures and the models applied to other exposures.

5.022 Nonderivative Instruments. Another inconsistency between foreign currency hedging models and other hedging models is the use of a nonderivative instrument as the hedging instrument. The cash flow and fair value hedging models under ASC Topic 815 do not permit the use of a nonderivative instrument as a hedging instrument. However, a nonderivative instrument can be a hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment or a foreign currency hedge of a net investment in a foreign operation. The reasons for this inconsistency are the same as noted in Paragraph 5.021. It is important to note that the use of a nonderivative instrument in conjunction with a foreign currency cash flow hedge is not permitted even if the entity is hedging the forecasted foreign currency cash flows related to an unrecognized firm commitment.

HEDGING REQUIREMENTS

5.023 Hedge accounting of foreign currency exposure generally requires compliance with the criteria for all hedges (ASC paragraphs 815-20-25-1 through 25-10), as well as those for fair value hedges (ASC paragraphs 815-20-25-11 and 25-12) or for cash flow hedges (ASC paragraphs 815-20-25-13 through 25-15). In addition, the conditions in ASC paragraph 815-20-25-30 also must be met for foreign currency hedges. The following table provides an overview on these hedging requirements.

Foreign Currency Fair Value Hedges	Foreign Currency Cash Flow Hedges
<ul style="list-style-type: none"> • Formal documentation at the inception of the hedge, including documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of all of the following: ASC subparagraph 815-20-25-3(b) <ul style="list-style-type: none"> • The hedging instrument • The hedged item or transaction • The nature of the risk being hedged • The method that will be used to retrospectively and prospectively assess the hedging instrument's effectiveness • If the entity is hedging foreign currency risk on an after-tax basis, that the assessment of effectiveness will be on an after-tax basis • For a firm commitment, a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment, ASC paragraph 815-20-25-3 	<ul style="list-style-type: none"> • Formal documentation at the inception of the hedge, including documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of all of the following: ASC subparagraph 815-20-25-3(b) <ul style="list-style-type: none"> • The hedging instrument • The hedged item or transaction • The nature of the risk being hedged • The method that will be used to retrospectively and prospectively assess the hedging instrument's effectiveness • If the entity is hedging foreign currency risk on an after-tax basis, that the assessment of effectiveness will be on an after-tax basis • For a cash flow hedge of a forecasted transaction: the date or period within which the forecasted transaction is expected to occur, the specific nature of the asset or liability involved (if any), the exact amount of foreign currency being hedged, identification of the current price of a forecasted transaction to satisfy the criteria in ASC subparagraph 815-20-25-75(b) for offsetting cash flows, and

5. Foreign Currency Derivatives and Hedging Foreign Currency Risk

	<p>a description of the forecasted transaction with sufficient specificity so that when the transaction occurs, it is clear whether that transaction is or is not the hedged transaction. ASC paragraph 815-20-25-3</p>
<ul style="list-style-type: none"> • High effectiveness of the hedging relationship, at inception and on an ongoing basis. ASC subparagraph 815-20-25-75(a) • Special rules for written options. ASC paragraphs 815-20-25-94 and 25-95 • A nonderivative should not be designated as a hedging instrument, except as a hedge of an unrecognized foreign currency-denominated firm commitment. ASC paragraph 815-20-25-58 • The hedged item may be all or a specific portion of a recognized asset or liability, or of an unrecognized firm commitment or a portfolio of similar assets or liabilities. ASC subparagraphs 815-20-25-12(a) and 25-12(b) 	<ul style="list-style-type: none"> • High effectiveness of the hedging relationship, at inception and on an ongoing basis. ASC subparagraph 815-20-25-75(b) • Special rules for written options. ASC paragraphs 815-20-25-94 and 25-95 • Special rules for basis swaps. ASC paragraphs 815-20-25-50 and 25-51 • A nonderivative should not be designated as a hedging instrument. ASC paragraphs 815-20-25-38 and 25-39 and 25-45 • If the hedged transaction is a group of forecasted transactions, those transaction must share the same risk exposure. ASC subparagraph 815-20-25-15(a) • Forecasted transactions must be probable. ASC subparagraph 815-20-25-15(b)
<ul style="list-style-type: none"> • The hedged item must present an exposure that could affect earnings. ASC subparagraph 815-20-25-12(c) • The hedged item is not prohibited from being designated as a hedged item. ASC paragraph 815-20-25-43^[1] • The risk designated being hedged can be hedged according to ASC subparagraphs 815-20-25-12(d) through 25-12(g). 	<ul style="list-style-type: none"> • The hedged item must present an exposure that could affect earnings. ASC subparagraph 815-20-25-15(c) • The hedged item is not prohibited from being designated as a hedged item according to ASC subparagraphs 815-20-25-15(d) through 25-15(h).^[1] • The risk designated being hedged can be hedged according to ASC subparagraphs 815-20-25-15(i) through 25-15(k).

5. Foreign Currency Derivatives and Hedging Foreign Currency Risk

<ul style="list-style-type: none"> • The operating unit that has the foreign currency exposure is a party to the derivative hedging instrument. ASC subparagraph 815-20-25-30(a) • The hedged transaction is denominated in a currency other than that unit's functional currency. ASC subparagraph 815-20-25-30(b) 	<ul style="list-style-type: none"> • The operating unit that has the foreign currency exposure is a party to the derivative hedging instrument. ASC subparagraph 815-20-25-30(a) • The hedged transaction is denominated in a currency other than that unit's functional currency. ASC subparagraph 815-20-25-30(b)
	<ul style="list-style-type: none"> • If the hedged transaction is a group of individual forecasted foreign currency denominated transactions, the group cannot include both forecasted inflows and outflows. ASC subparagraph 815-20-25-39(c) • All variability in a recognized foreign-currency denominated asset's or liability's functional currency-equivalent cash flows must be eliminated by the effect of the hedge. ASC subparagraph 815-20-25-39(d)
<p>^[1] The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria in ASC subparagraph 815-20-25-43(c)(3) and ASC subparagraph 815-20-25-15(d). Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates under ASC paragraphs 830-20-35-11.</p>	

5.024 Unlike hedges of other foreign currency exposures, net investment hedges are not subject to any hedge criteria mentioned above, except ASC paragraphs 815-20-25-30, the documentation requirements included in ASC subparagraph 815-20-25-3(b) and an entity must assess effectiveness at least quarterly and whenever financial statements or earnings are reported. In addition, net investment hedges are subject to the criteria of ASC paragraph 830-20-35-3, which are not changed by ASC Topic 815. Those criteria are that the hedging instrument must be designated and effective as an economic hedge of the net investment.

5.025 The types of transactions that are subject to hedges give rise to a number of issues that have particular relevance to foreign currency hedging. These issues, which are discussed in the KPMG Handbook, [Derivatives and hedging](#):

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- Hedging recognized foreign-currency-denominated assets or liabilities;
- Hedging intercompany transactions;
- Intercompany foreign currency derivative instruments (internal derivatives);
- Hedge effectiveness;
- Tandem or cross-currency hedging; and
- Determining when the hedged item is *denominated* in a foreign currency.

FOREIGN CURRENCY FAIR VALUE HEDGE

5.026 The hedged item in a foreign currency fair value hedge may be an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale debt security). To qualify as a fair value hedge, compliance with the hedging criteria in ASC Topic 815 and summarized in Paragraph 5.023 is required.

5.027 Unrecognized Firm Commitment. A characteristic of a firm commitment is that the price in the agreement is fixed. This does not require that the price be expressed in the entity's functional currency. Even if a firm commitment is denominated in currency other than the functional currency, an entity may account for a hedge of the commitment as a fair value hedge under ASC Topic 815. This view is based on the fact that ASC Topic 830 previously prescribed an accounting model similar to the fair value hedge accounting method for foreign-currency-denominated firm commitments, and with ASC Topic 815 the FASB did not want to change existing practice in this area without undertaking a complete reconsideration of ASC Topic 830. Because a firm commitment in a currency other than the entity's functional currency also exposes the entity to variability in cash flows due to changes in currency rates, it also may be a hedged transaction in a cash flow hedge of foreign currency risk.

Q&A 5.1: Unrecognized Firm Commitment

Q. Company A is a manufacturing company whose functional currency is the U.S. dollar. A major component in its manufacturing process (CPUs) comes from Company B, an unrelated Japanese supplier. No other supplier has a product that meets A's specifications. To ensure CPU availability, Company A enters into a contract with Company B to purchase a minimum of 1,000 CPUs each month for the next 12 months. The cost of each CPU is 10,000 yen. There are significant penalties if the contract is broken. Does Company A have a foreign-currency-denominated firm commitment that it can designate as the hedged item?

A. Yes. The definition of a firm commitment is prescribed in ASC Section 815-10-20. It requires that the commitment have, among other things, a fixed price and quantity, that the timing of the transaction be known, and that the agreement include a sufficiently large disincentive for nonperformance to make performance probable. The fixed price may be expressed as a specific amount of an entity's functional currency or of a foreign currency.

Company A's commitment has all of these features, including a fixed price, which has been specified in yen, a currency other than Company A's functional currency.

5.028 The definition of a firm commitment requires that the commitment be with an unrelated party. Thus, an intercompany commitment is prohibited from being designated as a hedged item in a fair value hedge. This proscription also includes a foreign-currency-denominated commitment with a related party outside the reporting entity. Therefore, such a commitment cannot be the hedged item in a fair value hedge. However, a foreign-currency-denominated commitment, with related parties (e.g., subsidiary to subsidiary in a consolidated group, operating entity to related party outside the consolidated group) may qualify as a forecasted transaction in a cash flow hedge under ASC subparagraph 815-20-25-28(b). This is because the criteria for forecasted transactions do not include the criterion that the contract be with an *unrelated party* and the intercompany or related party commitment does expose an entity to variability in functional-currency-equivalent cash flows that could affect reported earnings.

5.029 ASC subparagraph 815-20-25-37(d) allows a nonderivative foreign-currency-denominated financial instrument to be designated as a hedging instrument in a fair value hedge of the foreign currency exposure associated with an unrecognized firm commitment, as long as the nonderivative financial instrument gives rise to a foreign currency transaction gain or loss under ASC paragraph 830-20-35-1.

5.030 The nonderivative foreign-currency-denominated hedging instrument can be an intercompany instrument. If so, hedge accounting in the consolidated financial statements may be applied only if the counterparty to the intercompany nonderivative financial instrument has entered into an unrelated third-party nonderivative financial instrument that offsets the foreign currency exposure acquired from the entity with the firm commitment.

5.031 The gain or loss of a nonderivative instrument treated as a hedging instrument must continue to be recognized in accordance with ASC paragraphs 830-20-35-1 and 830-20-40-1 by reference to changes in spot exchange rates. By contrast, the gain or loss of a derivative instrument is measured by reference to changes in its total fair value.

5.032 Recognized Assets and Liabilities. A foreign-currency-denominated asset (including an available-for-sale debt security) or liability is eligible to be a hedged item, as long as the asset or liability is subject to recognition of foreign currency transaction gains or losses in net income under the provisions of ASC Subtopic 830-20, *Foreign Currency Matters - Foreign Currency Transactions*. The designation of nonderivative instruments as the hedging instrument for these hedged items is not allowed (see Paragraph 5.022).

5.033 For securities accounted for under ASC Subtopic 320-10, *Investments--Debt Securities - Overall*, the ability to hedge changes in fair value attributable to foreign exchange depends on the classification of these securities. Trading securities are not hedgeable under the foreign currency fair value model because they are recorded at fair

value, with changes in fair value reported in net income. Held-to-maturity debt securities are hedgeable under ASC subparagraph 815-20-25-37(a) with no additional special criteria because foreign currency transaction gains or losses are recognized directly in net income under the provisions of ASC paragraphs 830-20-35-1 and 830-20-40-1. Although foreign currency transaction gains or losses are not recognized directly in net income under the provisions of ASC paragraphs 830-20-35-1 and 830-20-40-1, available-for-sale debt securities are hedgeable under ASC paragraphs 815-20-25-37(b) and 25-37(c) and criteria prescribed therein.

5.034 Available-for-Sale Debt Securities. An available-for-sale debt security qualifies for a foreign currency fair value hedge if the hedging criteria mentioned in Paragraph 5.033 are met.

5.035 The FASB concluded that foreign-currency-denominated available-for-sale debt securities give rise to hedgeable foreign exchange risk because they embody cash flows denominated in a foreign currency.

5.036 Not used.

5.037 Accounting for Foreign Currency Fair Value Hedges. The accounting treatment for foreign currency fair value hedges is the same as for other fair value hedges. The derivative hedging instrument is accounted for at fair value with changes in fair value recognized in net income. The changes in fair value of the hedged item for the risk being hedged also are reflected in net income. If the hedged item is an unrecognized firm commitment and the hedging instrument is a derivative forward contract, an entity would not have volatility in the income statement if the changes in fair value of the hedged item are based on forward foreign currency exchange rates. Otherwise, if the spot exchange rate were used to calculate the change in fair value of the firm commitment due to changes in the foreign currency exchange rates, there would be volatility in earnings. The volatility is because the change in fair value of the derivative hedging instrument (which is calculated based on forward rates) would not equal the change in the hedged firm commitment (which is based on spot exchange rates).

5.038 The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under ASC Section 830-20-35. Under ASC paragraph 830-20-35-1, the foreign currency transaction gain or loss is determined as the increase or decrease in functional currency cash flows attributable to the change in spot exchange rates between the functional currency and the currency in which the hedging instrument is denominated. The foreign currency transaction gain or loss should be recognized in net income, along with the change in the carrying amount of the hedged firm commitment.

5.039 If an entity is hedging a recognized foreign-currency-denominated asset or liability, the assessment of effectiveness of the fair value hedging relationship due to changes in foreign currency rates is affected by the interaction of ASC Topic 815 and ASC Topic 830. The FASB decided not to reconsider all of the provisions of ASC Topic 830. ASC Topic 830 requires recognized foreign-currency-denominated assets and liabilities to be

remeasured to the functional currency based on spot exchange rates, with changes recognized in net income. Therefore, the adjustment of these assets and liabilities for changes in the *fair value* due to changes in foreign exchange rates is limited to the changes based on spot rates, while the change in fair value of the derivative hedging instrument is based on forward rates. If an entity does not exclude any components from the derivative hedging instrument in its assessment of hedge effectiveness, there will be earnings volatility for the spot-forward difference.

5.040 Hedging the change in fair value attributable to changes in both the benchmark interest rate and foreign exchange rate of a recognized interest-bearing foreign-currency-denominated financial asset or liability requires a two-step approach to adjust the basis of the hedged item. First, the hedged item is adjusted through net income for the change in fair value attributable to a change in the foreign benchmark interest rate. Second, the basis-adjusted (for changes in foreign benchmark interest rates) foreign-currency-denominated asset or liability is remeasured to the functional currency at the spot rate with changes recognized in net income. This approach effectively eliminates any difference that would be reflected in earnings related to the use of different measurement criteria for the hedged item and the hedging instrument.

FOREIGN CURRENCY CASH FLOW HEDGE

5.041 The hedged item in a foreign currency cash flow hedge may be the exposure to variability in the functional currency equivalent cash flows associated with a forecasted transaction, an unrecognized firm commitment, a recognized asset or liability or a forecasted intercompany transaction. To qualify as a foreign currency cash flow, compliance with the criteria in ASC Topic 815 and summarized in Paragraph 5.023 is required. The designation of a nonderivative financial instrument as a hedging instrument is not permitted in a foreign currency cash flow hedge.

5.042 Forecasted Transactions. As previously mentioned, the FASB decided to expand the scope of foreign currency cash flow hedges to allow an entity to hedge certain intercompany transactions, which is not permitted for other types of intercompany exposures (other cash flow hedges require the forecasted transaction to be with a party external to the reporting entity). ASC paragraphs 815-20-25-38 and 25-39 permit an entity to designate the foreign currency exposure to variability in the functional-currency-equivalent cash flows of forecasted foreign-currency-denominated transactions as a hedged transaction in a cash flow hedge, whether the transaction is with a third party or an intercompany transaction. The ability to designate a forecasted foreign-currency-denominated intercompany transaction as a hedged item in a foreign currency cash flow hedge exists because the forecasted transaction will ultimately give rise to variability in functional currency cash flows due to exchange rate changes that affect consolidated net income when remeasured under ASC Topic 830.

Q&A 5.2: Forecasted Transaction

Q. XYZ Company has forecasted an acquisition of inventory for 100,000 Swiss Francs (SF), which is not XYZ's functional currency, in six months. Can XYZ designate the foreign currency exposure inherent in the forecasted acquisition of the inventory as the hedged item in a cash flow hedge?

A. Yes. ASC paragraph 815-20-25-28 permits a forecasted acquisition of an asset to be designated as a hedged item in a foreign currency cash flow hedge.

5.043 For consolidated financial statements, an entity should reclassify to earnings the amounts in accumulated in other comprehensive income when the transaction affects *consolidated* earnings. For example, for a hedge of a forecasted intercompany purchase of inventory, amounts accumulated in other comprehensive income would be reclassified to earnings (e.g., cost of sales) when the hedged inventory is sold to a third party, because that is when it affects consolidated earnings. Further, because the purchase of inventory and sale to a third party may occur in different periods, an entity will need to have an established process to track and determine when amounts should be reclassified from other comprehensive income to earnings.

5.044 As stated in ASC subparagraph 815-20-25-39(c), if the hedged transaction is a group of individual forecasted foreign currency-denominated transactions, forecasted inflows of a foreign currency and forecasted outflows of the foreign currency cannot both be included in the same group. The reason for this is that forecasted foreign currency outflows and inflows have opposite risk exposures for which they are designated as being hedged and thus are not similar.

5.045 Unrecognized Firm Commitments. As noted in Paragraph 5.027, firm commitments in a currency other than the entity's functional currency may be subject to a foreign currency fair value hedge. In addition, because these commitments expose the entity to variability in its functional-currency-cash flows due to changes in currency rates, they may be the hedged items in cash flow hedges of foreign currency risk.

Q&A 5.3: Unrecognized Firm Commitments

Q. On January 1, ABC Corp. enters into an agreement to sell 1,000 tons of steel inventory to an unrelated party on June 30. The agreement meets the definition of a firm commitment in ASC Section 815-10-20. The firm commitment is denominated in the buyer's functional currency, which is not ABC's functional currency. Accordingly, the firm commitment exposes ABC to foreign currency risk. May ABC hedge that foreign currency exposure under the cash flow hedging model?

A. Yes. Although the definition of a firm commitment requires a fixed price, it permits the fixed price to be denominated in a foreign currency. Consequently, a firm commitment can expose an entity to variability in its functional-currency-equivalent cash

flows. The notion in the definition of a forecasted transaction that a forecasted transaction is not a firm commitment focuses on firm commitments that have no variability. The notion is not intended to preclude a cash flow hedge of the variability in functional-currency-equivalent cash flows when the commitment's fixed price is denominated in a foreign currency. The definition of a forecasted transaction also indicates that the transaction or event will occur at the prevailing market price. From the perspective of the hedged risk (foreign exchange risk), the translation of the foreign currency proceeds from the sale of the inventory will occur at the prevailing market price (i.e., current exchange rate). Accordingly, ABC may hedge the foreign currency exposure arising from the firm commitment to sell 1,000 tons of steel inventory under the cash flow hedging model, even if ABC had previously hedged its foreign currency exposure arising from another similar firm commitment under the fair value hedging model.

5.046 As mentioned in Paragraph 5.028, the definition of a firm commitment requires that the commitment be with an unrelated party. Thus, an intercompany commitment or a commitment with a related party outside the reporting entity cannot be the hedged item in a foreign currency fair value hedge. However, as noted above, foreign-currency-denominated commitments with related parties (e.g., subsidiary to subsidiary within a consolidated group, reporting entity to related party outside the consolidated financial statements) may qualify as forecasted transactions in a cash flow hedge because the criteria for forecasted transactions do not include a criterion that the contract be with an unrelated party and the intercompany or related party commitment exposes an entity to variability in functional-currency-equivalent cash flows that could affect reported earnings.

5.047 Recognized Foreign Currency-Denominated Assets and Liabilities. ASC subparagraph 815-20-25-39(d) states that a foreign-currency-denominated asset or liability may be designated as a hedged item in a foreign currency cash flow hedge if all variability in the hedged item's functional-currency-equivalent cash flows will be eliminated by the effect of the hedge. Otherwise, an entity could designate the recognized foreign currency-denominated asset or liability as a hedged item in a foreign currency fair value hedge only if all of the fair value hedge criteria are met.

Example 5.2: Recognized Foreign Currency Denominated Assets

A company that has the U.S. dollar as its functional currency and a fixed-rate yen-denominated loan could hedge the loan for variability in functional-currency-equivalent cash flow with a forward currency contract, because the yen interest payments are fixed and the forward currency contract eliminates the remaining variability due to foreign exchange rates. In contrast, the company could not hedge a variable-rate yen-denominated loan for variability in functional-currency-equivalent cash flow with a forward currency contract, because the forward currency contract eliminates only the variability due to foreign exchange rates and variability still exists due to the variable

interest rate. As further discussed in Example 5.3, an entity could hedge this loan with a cross-currency interest rate swap in the cash flow hedging model.

5.048 The requirement in ASC subparagraph 815-20-25-39(d) to eliminate all variability in cash flows is not intended to require that the hedging instrument be perfectly effective. The requirement to eliminate all variability is intended to ensure that the hedging relationship is highly effective at offsetting all risks that affect the variability of cash flows. Thus, ASC paragraph 815-20-25-39(d) precludes only the specific exclusion of a risk from the hedge that will affect the variability in cash flows. As long as the entity has specifically excluded no element of risk affecting the variability in cash flows from a foreign currency cash flow hedge, and the hedging instrument is highly effective at providing the necessary offset in the variability of all cash flows, a less-than-perfect hedge would meet the requirement in ASC paragraph 815-20-25-39(d). In other words, if the recognized foreign-currency-denominated asset or liability has a variable interest rate and an entity wishes to hedge the foreign exchange risk for both the principal and interest, the hedging relationship must offset the variability in cash flows for both foreign exchange risk and interest rate risk. The hedging relationship would have to fix the cash flows in terms of the entity's functional currency.

Example 5.3: Recognized Foreign Currency-Denominated Liability

DMA Company has issued a variable-rate foreign-currency-denominated debt obligation and desires to hedge its variability in functional-currency-equivalent cash flows due to changes in foreign currency rates and interest rates. DMA uses a floating-to-fixed cross-currency interest rate swap in which it receives an amount based on the variable rate index in the same foreign currency contained in the debt obligation, and pays a fixed amount in its functional currency. There is a 10-day difference between the reset dates in the debt obligation and the swap (that is, the 10-day difference in reset dates results in the hedge being highly effective, but not perfectly effective).

DMA Company could use a floating-to-fixed cross-currency interest rate swap to hedge the cash flow exposure due to foreign currency exchange and interest rate changes on the variable-rate foreign-currency-denominated debt instrument even though there is a 10-day difference between the reset dates in the debt instrument and the swap. This is true as long as the difference in reset dates is not significant enough to cause the hedge to fail to be highly effective at providing offsetting cash flows.

5.049 It is important to note that the carrying amount of a financial asset or liability, such as a loan, comprises the present value of the interest payments and the present value of the principal payment(s). An entity can specify as the hedged item specific cash flows (ASC subparagraph 815-20-25-15(j)) associated with all or a portion of the recognized foreign-currency-denominated principal and/or interest of a financial asset or liability. Consistent with ASC paragraph 815-20-25-41, if all of the variability of the functional-currency-equivalent cash flows is eliminated as a result of the hedge (as required by ASC subparagraph 815-20-25-39(d)), for either fixed or variable rate foreign-currency-

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denominated financial assets or liabilities, an entity is permitted to use cash flow hedge accounting to hedge the variability in functional-currency-equivalent cash flows for:

- All payments of both principal and interest;
- All payments of principal only;
- All or a fixed portion of selected payments of either principal or interest; and
- Selected payments of both principal and interest.

For each of these situations, an entity can use cash flow hedge accounting to hedge the variability in the specific principal repayments, interest cash flows, or both by applying the guidance in ASC subparagraph 815-20-25-39(d) to the specifically identified hedged cash flows.

5.050 The following table provides an overview on the various approaches to hedging foreign exchange risk in either fair value or cash flow hedges for recognized foreign-currency-denominated financial assets and liabilities.

Hedged Item	Hedge Objective¹	Hedge Result	Hedge Approach
Fixed-rate, foreign-currency denominated (FCD) instrument	Reduce foreign exchange (FX) and interest rate risk	US\$ variable rate interest and US\$ principal	Fair value hedge of FX and interest risk
Fixed-rate, FCD instrument	Fix variability due to FX risk	U.S.\$ fixed interest rate and US\$ principal	Cash flow or fair value hedge ² of FX risk
Fixed-rate, FCD instrument	Eliminate change in FCD fair value of instrument due to FCD interest rate risk	FCD variable rate interest and FCD principal	Fair value hedge of FCD interest rate risk
FCD trade payable or receivable	Fix variability due to FCD risk	US\$ fixed payment amount	Cash flow or fair value hedge ² of FX risk
Variable-rate, FCD instrument	Fix variability of principal and interest payments due to FX and interest risk ³	US\$ fixed rate interest and US\$ principal	Cash flow hedge of variability of FX and interest risk
Variable-rate, FCD instrument	Reduce variability of FX risk ³	US\$ variable rate interest and US\$ principal	Fair value hedge ² of FX risk ⁴

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Variable-rate, FCD instrument	Reduce variability due to interest risk	FCD fixed rate interest and principal	Cash flow hedge of variability of FCD interest
Variable-rate, FCD instrument	Fix variability of principal payment due to FX risk	Fixed US\$ principal	Cash flow or fair value hedge ² of FX risk for principal
<p>¹ Assumptions are that the US\$ is the functional currency and that the interest rate is the benchmark rate for a fair value hedge or the contractually specified interest rate for a cash flow hedge.</p> <p>² If no components are excluded from the assessment of hedge effectiveness, there may be volatility in earnings for the fair value hedging model due to spot/forward differences or currency basis spreads. Earnings volatility can be reduced if an entity excludes the spot/forward difference or currency basis spread from its assessment of hedge effectiveness and elects to recognize the initial value of the excluded component using an amortization approach.</p> <p>³ Alternatively, as discussed in Paragraph 5.049, the hedged item could be designated as the functional-currency-equivalent cash flows of a specified amount of a variable-based foreign currency interest payment(s). As an example, if an entity had a EUR 100,000 variable loan, it could designate as the hedged item the first EUR 3,000 of a specified variable rate interest payment(s) if it is probable that the hedged variable interest payment(s) will exceed EUR 3,000. It could then enter into a cash flow hedge with a foreign currency forward contract because all of the variability associated with the first EUR 3,000 of the variable interest payment(s) would be eliminated.</p> <p>⁴ Alternatively, as discussed in Paragraph 5.049 and as demonstrated in the last approach in the table, if the hedged item was designated to be the principal payment component only, the cash flow hedging model could be used.</p>			

5.051 Treasury Center – Internal Derivatives and Offsetting Net Exposure. An internal derivative is a derivative entered into with another member of the consolidated group. The member of the consolidated group that has the foreign currency exposure and is using the internal derivative as a hedging instrument (the hedging affiliate) in the consolidated financial statements must meet the criteria for foreign currency cash flow hedge accounting as discussed in ASC paragraph 815-20-25-39 and Paragraph 5.023.

5.052 ASC paragraph 815-20-25-52 provides that an internal derivative can be used in a fair value or cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment in a foreign operation hedge only if the counterparty to the internal derivative, usually a treasury center, has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the internal derivative. ASC paragraph 815-20-25-61 permits more flexibility when using internal derivatives to hedge the foreign currency cash flow risk associated with a forecasted borrowing, purchase, sale, or an unrecognized firm commitment. In this instance, the treasury center can either enter into an offsetting contract with an unrelated third party or, if the criteria of ASC subparagraph 815-20-25-62(d) are met, enter into derivative contracts with unrelated third parties that would offset, on an aggregate or net basis, the foreign exchange risk arising from multiple internal derivatives. In offsetting the various foreign currency exposures, a treasury center may enter into third-party derivatives with neither leg being in the treasury center’s functional currency. For example, if a U.S. dollar-functional currency treasury center was long yen and short euros, it could enter

into a yen/euro currency swap. Residual yen or euro exposure not offset by the currency swap would need to be separately offset.

5.053 If the entity decides to enter into derivative contracts with unrelated third parties that would offset, on an aggregate or net basis, the foreign exchange risk arising from multiple internal derivatives, the treasury center must act as a pass-through entity. ASC paragraph 815-20-25-62 outlines conditions that must be met for the treasury center to be considered a pass-through entity. See section 11 of KPMG Handbook, [Derivatives and hedging](#) for further discussion.

5.054 The provisions of ASC paragraphs 815-20-25-61 and 25-62 for aggregating or netting foreign currency risk cannot be used to offset exposures arising from internal derivatives related to recognized foreign-currency-denominated assets or liabilities or net investment hedges. This creates an issue for a treasury center that is aggregating or netting internal derivatives under ASC paragraphs 815-20-25-61 and 25-62 for cash flow hedges of forecasted transactions or unrecognized firm commitments once these transactions occur and become recognized assets or liabilities if the internal derivative has not yet matured. At the point a forecasted transaction or firm commitment occurs, an internal derivative that the treasury center aggregated or netted, for purposes of entering into third-party derivative contracts, would no longer qualify for hedge accounting in the consolidated financial statements.

5.055 Additionally, the treasury center must update the hedging documentation that links the third-party derivative to the aggregate or net internal derivatives remaining. If the conditions in ASC paragraph 815-20-25-62 were initially met, the remaining internal derivatives from this linked hedging relationship can continue to receive hedge accounting in the consolidated financial statements. The treasury center can enter into a third-party derivative to offset the effect for the internal derivative that no longer qualifies for aggregation or netting and essentially rebalance the offsetting hedging relationship to 100%. Alternatively, it could redesignate the excess portion of the third-party derivative related to the internal derivative that no longer qualifies for aggregation or netting to another hedging relationship or leave the existing third-party derivative alone and have a speculative position on that proportion of the third-party derivative.

Q&A 5.4: Treasury Center (Intercompany Derivatives #1)

Q. Finance Co.'s functional currency is the U.S. dollar. Finance acts as the central treasury function for all entities within its consolidated group, including London Co. and Tokyo Co. London's functional currency is the pound sterling (£). Tokyo's functional currency is the yen (¥). London has a forecasted transaction in which it expects to receive \$100 in three months. To hedge this exposure it enters into a foreign currency forward contract with Finance to sell \$100 and receive £75 in three months. Tokyo has a forecasted transaction in which it will pay \$150 in three months. To hedge its exposure, it enters into a foreign currency forward contract with Finance to buy \$150 and pay 15,000¥ in three months. As a result of these intercompany derivative contracts, Finance has a net position to pay £75 and receive 15,000¥ in three months and, therefore, has an

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exposure to both fluctuations in the \$/£ exchange rate and the \$/¥ exchange rate. Finance offsets these two exposures by entering into two foreign currency forward contracts with Bank A, an unrelated third party, to buy £75 for \$100 and to sell 15,000¥ for \$150 in three months. Can London and Tokyo apply cash flow hedge accounting in their stand-alone financial statements?

A. Yes. To qualify for cash flow hedge accounting, ASC subparagraph 815-20-25-30-(a)(1) requires that the operating unit with the foreign currency exposure must be a party to the hedging transaction. ASC paragraphs 815-20-25-52 and 25-61 clarify that a derivative instrument used in a cash flow hedge of a forecasted transaction may be between a parent and its subsidiary. On a stand-alone basis, both London and Tokyo have entered into a derivative instrument, which will be effective in hedging their foreign currency cash flow exposure.

Q&A 5.5: Treasury Center (Intercompany Derivatives #2)

Q. Can Finance apply hedge accounting in its stand-alone financial statements?

A. No. The risks that Finance acquired from the subsidiaries are derivative instruments. ASC Topic 815 does not permit entities to designate items recorded at fair value with adjustments recognized through net income as hedged items. The internal derivatives entered into by Finance with London and Tokyo will be remeasured at fair value through net income. Thus, Finance cannot designate the internal derivatives as hedged items. Finance will account for the derivative contract entered into with Bank A to offset the risks acquired in the internal derivatives with the subsidiaries as speculative (i.e., mark-to-market). The changes in the fair value of all three of these derivative contracts will offset in net income.

Q&A 5.6: Treasury Center (Intercompany Derivatives #3)

Q. Can the consolidated group apply cash flow hedge accounting?

A. Yes. In this circumstance, under ASC subparagraph 815-20-25-61(b)(1), Finance entered into derivative contracts with an unrelated third party (Bank A) to offset the exposures that resulted from the internal derivatives.

5.056 Accounting for Foreign Currency Cash Flow Hedges. The accounting for foreign currency cash flow hedges is the same as the accounting for other cash flow hedges. A derivative designated and effective as a cash flow hedge is recorded in the balance sheet at fair value. The change in a derivative instrument's fair value, except for any amount excluded from the assessment of hedge effectiveness, is reported in accumulated other comprehensive income. For additional guidance on accounting for the change in the component of a derivative's fair value that is excluded from the assessment of hedge

5. Foreign Currency Derivatives and Hedging Foreign Currency Risk

effectiveness, see section 10.2.20 of KPMG Handbook, [Derivatives and hedging](#) . The amount in accumulated other comprehensive income is reclassified to net income in the same periods during which the hedged item affects net income. We believe that such amounts should be reclassified from accumulated other comprehensive income each period to offset the transaction gain or loss arising from the ASC Topic 830 remeasurement of the foreign-currency-denominated asset or liability at the spot exchange rate.

5.057 If an entity is hedging the variability in functional-currency-equivalent cash flows involving recognized foreign-currency-denominated assets or liabilities, the accounting for the cash flow hedging relationship due to changes in foreign exchange rate is affected by the interaction of ASC Topic 815 and ASC Topic 830. ASC Topic 830 requires recognized foreign-currency-denominated assets and liabilities to be remeasured to the functional currency based on spot exchange rates through net income. Therefore, the adjustment of these assets and liabilities for changes in foreign exchange rates is limited to the changes based on spot rates, while Topic 815 requires recognition of all derivatives on the balance sheet at fair value and the fair value of the derivative hedging instrument is based on forward rates. If the cash flow hedge is highly effective, the change in fair value of the derivative is recognized in OCI while the remeasurement gain/loss of the monetary assets and liabilities is recognized in earnings. Without additional guidance to address this measurement difference, earnings volatility would occur.

5.058 Therefore, an exception to the general hedging guidance was provided for cash flow hedges of recognized FCD assets and liabilities when an entity assesses effectiveness based on total changes in the hedging instrument’s cash flows. The FASB decided to permit this exception because it believes it is consistent with its general principle of providing special hedge accounting to mitigate the effects in earnings of different existing measurement criteria for foreign currency denominated transactions.

5.058a. The following table describes this exception, which may not be applied by analogy to other hedging relationships.

Hedging instrument	Assessment of hedge effectiveness	Amount to be reclassified from AOCI into earnings
Non-option contract	Based on total changes in cash flows of the non-option contract	Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates. Portion of cost attributable to spot-forward difference amortized in earnings using the interest method.
Option contract	Based on total changes in cash flows of the option contract	Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the change in the underlying that results in a change in the option contract’s intrinsic value.

5. Foreign Currency Derivatives and Hedging Foreign Currency Risk

		Portion of cost of the option amortized in earnings on a rational basis.
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The following table describes the reclassification from AOCI into earnings if the assessment of hedge effectiveness is not based on the hedging instrument's total change in cash flows.

Hedging instrument	Assessment of hedge effectiveness	Amount to be reclassified from AOCI into earnings
Non-option contract	Spot-forward difference excluded from assessment of hedge effectiveness	<p>Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates.</p> <p>As discussed in section 10.2.20 of KPMG Handbook, Derivatives and hedging, an entity can recognize the initial value of the excluded component in earnings using either:</p> <ul style="list-style-type: none"> • Amortization approach. A systematic and rational method over the life of the hedging instrument; or • Mark-to-market approach. A method that recognizes all fair value changes of the excluded component currently in earnings
Option contract	Based on changes in intrinsic value of the option contract	<p>Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the change in the underlying that results in a change in the option contract's intrinsic value</p> <p>As discussed in section 10.2.20 of KPMG Handbook, Derivatives and hedging, an entity can recognize the initial value of the excluded component in earnings using either:</p> <ul style="list-style-type: none"> • Amortization approach. A systematic and rational method over the life of the hedging instrument; or • Mark-to-market approach. A method that recognizes all fair value changes of the excluded component currently in earnings

The initial spot-forward difference for a forward contract or the premium paid for an option contract represents the cost to the purchaser or income to the seller of the hedging instrument.

5.059 Single Derivative Cash Flow Hedge. Foreign currency exposures related to specific types of transactions give rise to different hedging strategies using only one hedging model or a combination of hedging models, as described in ASC paragraph 815-20-25-34.

5.060 ASC paragraphs 815-20-25-34 through 25-36 indicate that an entity may choose to designate a cash flow hedge of the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable, all with the same derivative hedging instrument. With this approach, the cash flow hedge would terminate and the derivative instrument would be dedesignated when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. The entity could then redesignate the derivative instrument as the hedging instrument in a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. If an entity applied this alternative and assesses hedge effectiveness using forward rates, it will need to consider the mismatch of the hedging instrument's fair value being based on a time period to settlement date, whereas the change in forecasted cash flows is calculated based on a shorter time period (through the sale or purchase date).

5.061 Alternatively, an entity could designate a derivative instrument as the hedging instrument in a single cash flow hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flows associated with the forecasted transaction (i.e., sale or purchase on credit) and related settlement of the resultant foreign-currency-denominated receivable or payable. Generally, entities use a single cash flow hedge with a dual purpose to avoid operational issues associated with using two separate hedges.

5.062 Section 11 of KPMG Handbook, [Derivatives and hedging](#) provides detailed guidance about the implications of hedging foreign currency risk related to a forecasted foreign-currency-denominated sale or purchase with a single derivative, as described above.

HEDGE OF FOREIGN CURRENCY EXPOSURE OF A NET INVESTMENT IN A FOREIGN OPERATION

5.063 A net investment in a foreign operation includes incorporated and unincorporated business structures such as subsidiaries, divisions, branches, joint ventures, consolidated variable interest entities and investments accounted for by the equity method. The hedge of foreign currency exposure of a net investment in a foreign operation can be considered, under ASC Topic 815, the same as designating a group of dissimilar assets and liabilities as a hedged item, which is not permitted for a fair value or cash flow hedge. However, ASC Topic 830 previously permitted hedge accounting of net investments in a foreign operation and practice in this area was well established. Because the FASB did not comprehensively reconsider the accounting provisions of ASC Topic

830 and it was explicitly permitted by the literature, it decided to continue to permit hedging of net investment in a foreign operation.

5.064 An entity may designate both derivatives and nonderivative financial instruments that give rise to a foreign currency transaction gain or loss under ASC Topic 830 as hedging instruments in a hedge of a net investment in a foreign operation. A nonderivative financial instrument that is reported at fair value, such as an instrument to which an entity has chosen to apply the fair value option under ASC Topic 825, *Financial Instruments*, cannot be the hedging instrument because it does not give rise to a foreign currency gain or loss under ASC Topic 830.

Q&A 5.7: Net Investment Hedge

Q. Parent's functional currency is the U.S. dollar. Parent has a U.K. subsidiary and its functional currency is the pound sterling (£). Parent issues a debt obligation denominated in £ and uses the proceeds to finance its U.S. operations. Can Parent designate the £ debt obligation payable to third parties as a hedge of the net investment in the U.K. operation?

A. Yes. ASC paragraph 815-20-25-66 permits a nonderivative financial instrument that gives rise to a foreign currency transaction gain or loss to be used as the hedging instrument in a hedge of a net investment in a foreign operation.

5.065 The derivative or nonderivative hedging instrument can be with either a third party or a related party. However, if a parent company uses an internal derivative or a nonderivative financial instrument as a hedging instrument in a net investment hedge, the internal derivative or nonderivative financial instrument must be offset with a third party on an individual basis to obtain hedge accounting in the consolidated financial statements.

5.066 Net investment hedges are subject to the criteria of ASC paragraph 830-20-35-3, which ASC Topic 815 does not change. Those criteria are that the hedging instrument must be designated and effective as an economic hedge of the net investment. In addition, the hedge criteria specified in ASC paragraph 815-20-25-30 and the documentation requirements specified in Paragraph 5.023 apply, and an entity must assess effectiveness at least quarterly and whenever financial statements or earnings are reported. Various issues related to hedges of the foreign currency exposure of a net investment in a foreign operation, which are discussed in detail in section 12 of KPMG Handbook, [Derivatives and hedging](#).

5.067 Accounting for a Hedge of a Net Investment in a Foreign Currency. As indicated in ASC paragraph 815-35-35-1, the gain or loss on a derivative instrument that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation should be reported in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment).

5. Foreign Currency Derivatives and Hedging Foreign Currency Risk

5.068 As indicated in ASC paragraph 815-35-35-12, for nonderivative hedging instruments when a hedging relationship is effective as an economic hedge, the foreign currency transaction gain or loss on remeasurement at the spot rate (after tax effects, if appropriate) is reported in the same manner as the translation adjustment associated with the hedged net investment (i.e., in the cumulative translation adjustment in accumulated other comprehensive income).

5.069 ASC Topic 815 permits hedging foreign currency risk on an after-tax basis, provided that the documentation of the hedge at its inception indicated that the assessment of effectiveness will be on an after-tax basis (rather than on a pre-tax basis). If an entity has elected to hedge foreign currency risk on an after-tax basis, it must adjust the notional amount of its derivative appropriately to reflect the effect of tax rates.

Section 6 - Income Taxes under ASC Topic 740

See KPMG Handbook, [Accounting for Income Taxes](#).

Section 7 - Presentation and Disclosures

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TRANSACTION GAINS OR LOSSES

7.000 Aggregate Transaction Gains or Losses. ASC paragraphs 830-20-45-1 and 45-2 and 830-20-50-1 require that the aggregate foreign currency transaction gains or losses included in determining net income for the period be presented in the financial statements or disclosed in the notes to the financial statements. That amount includes transaction gains or losses that may have been reclassified to other income statement components, including sales, cost of sales, and interest income or expense in certain instances in highly inflationary economies. Banks and other dealers in foreign exchange may disclose these transaction gains or losses as dealer gains or losses rather than as transaction gains or losses.

7.001 Distinguishing Between Foreign Exchange and Credit Losses. Circumstances may arise where it is unclear whether the impact to net income is a foreign exchange or a credit loss. For example, assume a government implements monetary policy changes that require redenomination of consumer loans from one currency to a different currency that result in losses. These losses may be considered foreign exchange losses as a result of the redenomination of the consumer loans by the government, and not a credit loss. Determining whether a loss is a foreign exchange loss or a credit loss is based on specific facts and circumstances. Before measuring any foreign exchange loss on a redenomination, a credit analysis should be completed to ensure any appropriate credit loss was measured and recognized.

7.002 Classification of Transaction Gains or Losses from Operations in Highly Inflationary Economies. ASC Topic 830, *Foreign Currency Matters*, requires that the reporting currency be treated as if it were the functional currency for operations in highly inflationary economies. The remeasurement from the local currency to the reporting currency can create significant transaction gains or losses and, in the view of some entities, creates substantial *distortion* in the income statement. Alternative classifications of such transaction gains or losses in the financial statements are acceptable, provided that the entity disclose the aggregate foreign currency transaction gain or loss included in net income for the period. Those classifications should be consistent with the source of the transaction gain or loss (i.e., the monetary asset or liability whose remeasurement generated the transaction gain or loss) and be disclosed adequately in the financial statements.

Example 7.1: Alternative Classifications of Foreign Exchange Gains/Losses for Highly Inflationary Economies

Company B has local currency borrowings that bear interest at very high rates in certain highly inflationary economies. Due to constant devaluation of the local currency relative to the U.S. dollar, significant transaction gains are generated on remeasuring the local currency debt into the U.S. dollar. In this case, Company B may want to reclassify its foreign currency transaction gains on remeasurement of the local currency debt against interest expense on the debt.

7.003 In the situation described in Example 7.1, the income statement caption should be appropriately captioned, such as “interest expense, net of related foreign currency adjustments,” and full disclosure should be made of the classification in the notes to the financial statements. It also would be acceptable to record these aggregate transaction gains or losses in one line item in the income statement.

7.004 Change in Deferred Foreign Tax Assets and Liabilities. Entities have the option of reporting transaction gains or losses resulting from the remeasurement of deferred foreign tax assets or liabilities within deferred tax benefit or expense such as when that presentation is considered more useful than an alternative presentation method. If transaction gains or losses are presented in this manner, those gains or losses must still be included in the disclosure of the aggregate transaction gain or loss for the period as required by ASC paragraphs 830-20-45-1 and 50-1. ASC paragraphs 830-20-45-1 and 45-3, 830-20-50-1, 830-740-45-1

CUMULATIVE TRANSLATION ADJUSTMENT

7.005 Reporting Translation Adjustments. As discussed in Section 4, *Translation of Foreign Currency Financial Statements*, translation adjustments result from the process of translating financial statements from an entity’s functional currency into the reporting currency. Translation adjustments are not included in determining net income, but are instead reported as a component of other comprehensive income. ASC paragraph 830-30-45-19 indicates that the accumulated amount in equity may be called “Equity Adjustment from Foreign Currency Translation” or given a similar title (i.e., cumulative translation adjustment). ASC paragraph 830-30-45-12

7.006 Translation adjustments attributable to noncontrolling interests should be allocated to and reported as part of the noncontrolling interest in the consolidated reporting entity. ASC paragraph 830-30-45-17[

7.007 If an investor accounts for an investment in a foreign entity using the equity method, the investor's financial statements should report a translation adjustment in other comprehensive income. Thus, two equity pickups for a foreign investee would be recognized:

- The net income pickup (investor's ownership percentage of investee's translated net income); and
- The other comprehensive income pickup, including the investor's share of any cumulative translation adjustment on the investee's books. An additional translation adjustment would arise from translation of the investee's financial statements into the investor's functional currency.

7.008 Analysis of Change in Cumulative Translation Adjustment. An entity is required to disclose and analyze the changes during the period in the cumulative translation adjustment balance reported in equity. This analysis may be disclosed in a

separate financial statement, in the notes to the financial statements, or in the statement of changes in stockholders' equity. ASC paragraph 830-30-45-18

7.009 ASC paragraph 830-30-45-20 requires the analysis to include, at a minimum:

- Beginning and ending amount of cumulative translation adjustments;
- The aggregate adjustment for the period resulting from translation adjustments and gains and losses from certain hedges (hedge of a net investment in a foreign operation) and intra-entity balances (those of a long-term investment nature);
- The amount of income taxes for the period allocated to translation adjustments; and
- The amounts transferred from cumulative translation adjustments and included in determining net income for the period as the result of (1) losing a controlling financial interest in a foreign entity, (2) selling all or part of an equity method investment in a foreign entity, (3) disposing of a group of net assets in a foreign entity that constitute a business, or (4) complete or substantially complete liquidation of an investment in a foreign entity.

7.010 Income Taxes Related to Translation Adjustments. ASC Subtopic 740-10, *Income Taxes - Overall*, requires income tax expense to be allocated among income from continuing operations, discontinued operations, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other equity accounts. All translation adjustments are reported within other comprehensive income. ASC paragraph 830-30-45-21 states that income taxes related to those translation adjustments should be allocated to other comprehensive income. See Section 7, Foreign Operations of KPMG Handbook, [Accounting for Income Taxes](#), for additional guidance on foreign currency related income tax accounting matters.

EXCHANGE RATE CHANGES

7.011 Exchange Rate Changes after the Balance Sheet Date. ASC paragraphs 830-20-35-8, 830-20-50-2, 830-30-45-16, and 830-30-50-2 indicate that disclosure of significant effects on unsettled foreign currency transactions of a rate change occurring after the balance sheet date (or after the date of foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the entity's financial statements, in the case of different fiscal year-ends) may be necessary. This disclosure should include a consideration of changes in unsettled transactions from the date of the balance sheet to the date the rate changed. If it is not practicable to determine these changes, this fact should be stated. However, the financial statements should not be modified for a change in the exchange rate that occurs after the reporting entity's balance sheet date.

7.012 Disclosure of significant effects on unsettled foreign currency transactions of subsequent exchange rate changes is desirable because reporting currency cash flows will be affected if the rate change prevails at the time of settlement (i.e., there is an economic

exposure). Disclosure may be required in *Management's Discussion and Analysis of Financial Condition and Results of Operations* (MD&A) of public entities if future cash flows are expected to be significantly affected.

7.013 Disclosure of the effects of subsequent rate changes on foreign functional currency financial statements generally is not considered necessary because the translation process does not affect reporting currency cash flows (i.e., there is no economic exposure).

7.014 Effects of Rate Changes on Results of Operations. As discussed in ASC paragraph 830-20-50-3, entities are encouraged to include an analysis and discussion of the effects of rate changes on the reported results of operations within their note disclosures. Such disclosures may include the quantitative effects of translating revenue and expenses at rates that are different from those used in a preceding reporting period as well as the economic effects of rate changes (e.g., on selling prices, sales volumes, or cost structures).

7.015 Currency Devaluation. A currency devaluation is an official change to the fixed exchange rate enacted by the government that makes the local currency cheaper relative to other currencies. The SEC staff has indicated that the following disclosures, at a minimum, should be made in MD&A in the event of a currency devaluation:

- The timing and implications of the devaluation, both from an accounting and operational standpoint;
- An estimate of the financial effect of the devaluation, including gains and losses on monetary items if the devaluation occurs after the date of the financial statements as well as actual amounts recognized if it occurs before;
- Discussion of changes in profitability related to the currency devaluation's increase in the cost of imports and in-country sales prices of imported goods;
- Discussion regarding possible government pressures on vendors not to change sales prices and the expected effect on profitability subsequent to the currency devaluation;
- Business practices or policies that have changed or are expected to change in response to the devaluation; and
- The effect the devaluation had, or is expected to have, on the entity's compliance with debt covenants.

DERIVATIVE AND HEDGING RELATIONSHIP DISCLOSURES

7.016 Derivative and Hedging Relationship Disclosures. ASC paragraphs 815-10-50-1 through 50-1A require certain qualitative and quantitative disclosures about those derivative instruments and nonderivative instruments that are designated and qualify as hedging instruments. An entity should disclose information to enable users to understand how and why the entity uses derivative or nonderivative instruments and how such instruments and related hedge items are accounted for under ASC Topic 815, *Derivatives*

and Hedging, and effect the entity's (1) financial position, (2) financial performance, and (3) cash flows. An entity should also disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, its strategies for achieving those objectives, and information that would enable users of its financial statements to understand the volume of its activity in those instruments.

7.017 ASC paragraph 815-10-50-2 states that the disclosure should distinguish between derivative instruments (and nonderivative instruments) used for risk management purposes that are (1) designated as (a) fair value hedging instruments, (b) cash flow hedging instruments, and (c) hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation; and (2) derivatives used as economic hedges and for other purposes related to the entity's risk exposures. For derivative instruments not designated as hedging instruments, ASC paragraph 815-10-50-4 states that the disclosure should indicate the purpose of the derivative activity. Qualitative disclosures about an entity's objectives and strategies for using derivative instruments may be more meaningful if the entity describes the objectives and strategies in the context of its overall risk management profile related to interest rate risk, foreign exchange risk, commodity price risk, credit risk, and equity price risk.

7.018 Overall Quantitative Disclosures. In addition to the qualitative disclosures, entities holding or issuing derivative instruments (and nonderivative instruments that are designated and qualify as hedging instruments) are required to disclose quantitative information as required by ASC Section 815-10-50. There are additional quantitative disclosures in ASC Section 815-30-50 for derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions.

7.019 – 7.020 Not used.

7.021 Reporting Changes in the Components of Comprehensive Income. As part of the disclosures of accumulated other comprehensive income under ASC paragraph 220-10-45-14, ASC paragraph 815-30-50-2 requires entities to separately disclose the following:

- the beginning and ending accumulated derivative gain or loss,
- the related net change associated with current period hedging transactions,
- the net amount of any reclassification into earnings, and
- the difference between the change in fair value of an excluded component and the initial value of that excluded component recognized in earnings under a systematic and rational method in accordance with paragraph 815-20-25-83A.

See section 8.2.20 of KPMG Handbook, [Derivatives and hedging](#).

7.022 Not used.

ADDITIONAL DISCLOSURE CONSIDERATIONS

7.023 The SEC staff has elaborated on supplemental disclosures within MD&A about foreign currency exposure. SEC Financial Reporting Release No. 6 (Section 501.09 in the *Codification of Financial Reporting Policies*), encourages experimentation with narrative information about foreign currency exposure without specifying the location or nature of particular disclosures to be made. In general, the types of disclosures about the degree of exposure to exchange rate risk encouraged by the SEC staff include:

- Net investment by major functional currency.
- Analysis of the translation component of equity either by significant functional currency or by the geographical areas used for segment disclosure purposes.
- Liquidity and capital resource considerations related to (1) foreign operations with foreign functional currencies, as the functional currency cash flows of such entities may not be available to meet the parent's short-term needs for cash, (2) intracompany financing practices, and (3) significant foreign operations conducted in highly inflationary economies in which environmental characteristics mitigate against remittance to the parent.

7.024 Multiple Exchange Rate Systems. Strict exchange controls put in place by the Venezuelan government have limited the ability of many entities to exchange Venezuelan currency into U.S. dollars at an official government exchange rate. Largely due to these strict exchange controls, a parallel market had developed whereby entities were effectively able to convert Venezuelan currencies into U.S. dollars at a less favorable rate. Depending on an enterprise's facts and circumstances, they may have used both exchange mechanisms to convert Venezuelan currency into U.S. dollar. Questions have arisen in practice about the appropriate disclosures when multiple rates are present. As a result, at the Center for Audit Quality SEC Regulations Committee meeting with the SEC staff in April 2010, the SEC staff shared example MD&A disclosures that may help an investor understand how a multiple exchange rate system affects a registrant's financial position and results of operations. While the following example disclosures provided by the SEC staff were developed in the context of the Venezuelan currency rate environment, we believe that they also may be relevant for entities with operations in other countries that have multiple exchange rates: ([SEC Regulations Committee](#))

- Disaggregated financial information about operations within the foreign country (e.g., summarized balance sheets, income statements, and cash flow statements);
- Exchange rates used for translation from the local currency into U.S. dollars as well as an explanation of any changes in the rate used;
- If the entity changed rates, the (1) amount included in other comprehensive income related to the foreign country as a result of the change and (2) the effect of the different exchange rate on the results of operations and the carrying amounts in the balance sheet;

- The exchange rate(s) used for remeasurement purposes;
- Net monetary assets and liabilities that are exposed to exchange rate changes (e.g., measurement and settlement of monetary items may potentially occur at different rates);
- The amount of local currency pending approval for settlement into U.S. dollars (e.g., if there are delays or restrictions) and the length of time pending approval;
- Discussion of the foreign country's exchange rate systems and the effects on a registrant's operations in that country, including the effect on cash flows; and
- Discussion of the government's actions related to exchange rates, including the registrant's ability to settle transactions at these rates.

7.024a In addition to the above, we believe it would be useful for an entity to consider disclosing:

- Information so that a reader can understand the legally available exchange rate mechanisms used during the period and the implications to operations (e.g., remeasurement gain or loss) if other legally available exchange rate mechanisms had been used; and
- The potential financial statement impact if the reporting entity were to deconsolidate the foreign entity.

7.025 In circumstances where reported balances for financial reporting purposes differ from the actual U.S. dollar denominated balances held by a foreign subsidiary because different rates were used for remeasurement and translation purposes, ASC paragraph 830-30-S99-1 states that at a minimum, public entities should disclose the following information when material:

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

Example 7.2: Dollar Distortion Resulting from the Use of Different Exchange Rates for Remeasurement and Translation Purposes

Assume that a foreign subsidiary (using the local currency as its functional currency) of a U.S. parent holds \$1,000 U.S. dollars in an offshore bank account and that the foreign subsidiary is not domiciled in a highly inflationary economy. Because the U.S. dollar cash balance is a foreign currency transaction from the standpoint of the foreign subsidiary, this cash would be periodically remeasured into the subsidiary's functional currency. If the offshore U.S. dollars would be converted into the local currency using a penalty rate (6LC = US\$1), this remeasurement would result in the foreign subsidiary recording LC6,000 in its financial statements. Because of the foreign subsidiary's facts and circumstances, the LC6,000 is then translated at a preference rate (2LC = US\$1) for purposes of the U.S. parent's consolidated financial statements, resulting in cash of \$3,000 reflected in consolidation. In this case, the U.S. parent (reporting entity) is required to disclose the information addressed within Paragraph 7.025 because the reported cash balance of the foreign subsidiary for financial reporting purposes (\$3,000) differs from the actual U.S. dollar cash balance held by the foreign subsidiary (i.e., a dollar distortion exists). See Paragraph 4.062 for guidance about the accounting for dollar distortion differences.

7.026 SEC Requirements of Quantitative and Qualitative Disclosures. Regulation S-K Item 305, *Qualitative and Quantitative Disclosures about Market Risks*, requires qualitative (i.e., descriptive) and quantitative disclosures with respect to the following market-risk-sensitive instruments:

- derivative financial instruments, generally as defined in ASC Topic 815;
- other financial instruments, generally as defined in ASC Subtopic 825-10; and
- derivative commodity instruments, such as commodity futures, forwards, and swaps that are permitted by contract or custom to be settled in cash.

For foreign private issuers, certain quantitative and qualitative disclosures about market risk are required under Form 20-F, Item 11.

7.027 Risks and Uncertainties. ASC Topic 275, *Risks and Uncertainties*, requires an entity to disclose, among other information, current vulnerability due to concentrations in the market or geographic area in which it conducts its operations. For purposes of this disclosure, it is always considered at least reasonably possible that operations outside an entity's home country will be disrupted in the near term. If disruption of those operations could have a near-term severe effect on the entity, the nature of the risk and the carrying amounts of net assets and the geographic areas in which they are located should be disclosed. ASC paragraphs 275-10-50-18, 50-20, 55-21

7.028 Disclosure about Segments of a Foreign Operation of a Public Entity. ASC paragraph 280-10-50-41 requires, unless impracticable, public entities to disclose geographic information related to:

- Revenues from external customers attributed to the public entity's country of domicile and attributed to all foreign countries in total from which the public entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues should be disclosed separately. The basis for attributing revenues from external customers to individual countries should also be disclosed; and
- Long-lived assets other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets, located in all foreign countries in total and, separately, material amounts in individual foreign countries.

7.029 In addition, SEC registrants are required by ASC paragraph 235-10-S99-1 to disclose the components of income (loss) before income tax expense (benefit) generated from either domestic or foreign operations.

7.030 Other Considerations for Foreign Operations. Because assets held in certain countries may have risk associated with realization by a U.S. owner, the uncodified guidance in paragraph 5 of Chapter 12, "Foreign Operations and Foreign Exchange," of Accounting Research Bulletin 43, *Restatement and Revision of Accounting Research Bulletins*, requires an enterprise to consider carefully, in view of all the facts and circumstances, foreign earnings reported beyond the amounts received in the United States or available for distribution. Enterprises should consider disclosing these amounts, if significant. Disclosures may also be appropriate if significant earnings (losses) are generated or significant assets are located in:

- Countries experiencing or having a history of political unrest, or
- Highly inflationary economies.

7.031 Highly Inflationary Status. If a country in which a reporting entity has operations becomes highly inflationary as discussed in ASC paragraph 830-10-45-11, the SEC staff has indicated that registrants should disclose in MD&A the (1) timing of, and the economic factors that led to that country becoming a highly inflationary economy; and (2) a discussion of how the change in the functional currency will affect the registrant's accounting and financial reporting.

7.032 Use of a currency other than the US dollar. US domestic registrants and foreign issuers that do not meet the definition of foreign private issuers are required to present their financial statements in US dollars. In limited instances, the SEC staff has not objected to the use of a different reporting currency. See question 2.4.25 of KPMG Handbook, [Financial statement presentation](#), for additional guidance on those limited instances.

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