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Preface

August 2017

To the clients, friends, and people of Deloitte:

We are pleased to present A Roadmap to Foreign Currency Transactions and Translations. This Roadmap provides Deloitte’s insights into and interpretations of the accounting guidance under ASC 830 and IFRSs (in Appendix C). While the guidance in ASC 830 has not changed significantly over the years, the application of the existing framework has continued to evolve as a result of the increasing interdependence and complexity of international economies and companies’ legal structures.

This Roadmap reflects guidance that is effective for annual reporting periods beginning on or after January 1, 2017. Each chapter of this publication typically starts with a brief introduction and includes excerpts from ASC 830, Deloitte’s interpretations of those excerpts, and examples to illustrate the relevant guidance (highlighted by “Connecting the Dots” icons). This publication also addresses relevant SEC considerations and highlights from the meetings of the AICPA SEC Regulations Committee’s International Practices Task Force (highlighted by “SEC Considerations” icons). In addition, the Roadmap identifies limited pending content from recently issued ASUs (highlighted by “Changing Lanes” icons). Readers should refer to the transition guidance in the ASC or in the relevant ASU to determine the effective date(s) of the pending guidance.

Note that this Roadmap is not a substitute for the exercise of professional judgment, which is often essential to applying the requirements of ASC 830. It is also not a substitute for consulting with Deloitte professionals on complex accounting questions and transactions.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART’s home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We hope that you find this publication a valuable resource when considering the accounting guidance on foreign currency transactions and translations.

Sincerely,

Deloitte & Touche LLP

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1 For a list of abbreviations used in this publication, see Appendix E. For the full titles of standards, topics, and regulations used in this publication, see Appendix D.
Acknowledgments

Mario Enxuto and Dennis Howell supervised the overall preparation of this Roadmap and extend their appreciation to all professionals who helped in its development, particularly the other core members of the working group, including Nick Tricarichi, Rachel Grandovic, and Christine Reicheneder.

They would also like to acknowledge the members of our Production group for their contributions — especially Michael Lorenzo, the Production group leader; Joseph Renouf, who made the “accounting-speak” understandable; Jeanine Pagliaro, who copyedited the document; and Teri Asarito and Dave Frangione, who designed the Roadmap’s layout and graphics. They also wish to thank Deloitte’s U.S. Accounting Services groups, particularly Ignacio Perez and Karen Wiltsie.
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Chapter 1 — Introduction

Since the issuance of FASB Statement 52 (codified in ASC 830) in 1981, domestic and international economies have become increasingly interdependent. As a result, international operations have become more complex and generally represent a much larger portion of a company's overall financial results. At the same time, through both international expansion and corporate reorganization, the structures of many multinational corporations have become much more intricate. For example, many corporations are now organized as a series of holding companies that have no significant operations and only hold investments in other entities within the group. In addition, certain significant global functions (e.g., treasury) may now be performed entirely outside the United States and may transact in many different currencies.

However, despite such changes in the ways companies are organized and operated, the guidance codified in ASC 830 has not changed significantly over the years. ASC 830 assumes that the reporting entity uses the USD as its reporting currency and that its foreign operations are either (1) self-contained and integrated into a particular country or economic environment or (2) extensions of the reporting entity. As a result, companies may encounter challenges in applying such guidance to their current operating structures (discussed above) because their foreign operations may not fit cleanly into either of the two types contemplated in ASC 830. For example, the treasury function mentioned above may transact in virtually every currency and operate independently from the reporting entity. That is, it neither (1) is contained in a particular economic environment nor (2) is an extension of the reporting entity.

The goal of this Roadmap is to help entities understand and apply ASC 830 in today’s global business environment. In addition to summarizing the accounting framework in ASC 830 and providing an in-depth discussion of its key concepts, the Roadmap includes examples to illustrate how these concepts should be applied in practice.

1.1 Scope and Scope Exceptions

As indicated in ASC 830-10-15, all entities and all foreign currency transactions are within the scope of ASC 830 regardless of which currency is selected as the reporting currency. Therefore, if a reporting entity uses its local currency as the reporting currency and prepares its financial statements in accordance with U.S. GAAP, it must apply ASC 830. However, in these instances, ASC 830 would not apply for purposes “other than consolidation, combination, or the equity method” (i.e., convenience translations).

SEC Regulation S-X, Rule 3-20(b), provides guidance on presenting convenience translations for foreign private issuers and states, in part, “If the reporting currency is not the U.S. dollar, dollar-equivalent financial statements or convenience translations shall not be presented, except a translation may be presented of the most recent fiscal year and any subsequent interim period presented using the exchange rate as of the most recent balance sheet included in the filing, except that a rate as of the most recent practicable date shall be used if materially different.” In addition, SEC rules require foreign private issuers to disclose prominently on the face of the financial statements the currency in which
amounts in the financial statements are stated. Further, if dividends on publicly held equity securities are declared in a currency other than the reporting currency, a note to the financial statements should identify that currency.

1.2 Objective of ASC 830

The primary objective of ASC 830 is for reporting entities to present their consolidated financial statements as though they are the financial statements of a single entity. Therefore, if a reporting entity operates in more than one currency environment, it must translate the financial results of those operations into a single currency (referred to as the reporting currency). However, this process should not affect the financial results and relationships that were created in the economic environment of those operations.

In accordance with the primary objective of ASC 830, a reporting entity must use a “functional-currency approach” in which all transactions are first measured in the currency of the primary economic environment in which the reporting entity operates (i.e., the functional currency) and then translated into the reporting currency.

1.3 Functional-Currency Approach

Under the functional-currency approach, the reporting entity must do four things:

1. Identify each distinct and separable operation within the consolidated group.
2. Determine the functional currency for each distinct and separable operation.
3. Measure in the functional currency the assets, liabilities, and operations of each distinct and separable operation.
4. Translate those amounts into the reporting currency.

Because the functional-currency approach requires an entity to measure the assets, liabilities, and operations in the functional currency, an entity that enters into transactions in currencies other than its functional currency must first remeasure those amounts in its functional currency before they are translated into the reporting currency.
Connecting the Dots

It is important to understand the difference between remeasurement and translation under ASC 830. By remeasuring financial results in the functional currency, an entity provides information about its future net cash flows. That is, as exchange rates fluctuate, so too will the related cash flows. For this reason, the effects of remeasurement are generally reported in the income statement. Translation, on the other hand, simply refers to the process of converting the financial statements from the functional currency into a different currency. In other words, the translation process has no impact on an entity’s future cash flows. For this reason, the effects of translation are reported in equity.

To illustrate the application of the functional-currency approach under ASC 830, we have further divided this section into the following two subsections:

- **“Decision Points”** — This section discusses the two key decisions that management must make to apply the functional-currency approach: (1) identify the distinct and separable operations and (2) determine the functional currency of each. Management must use judgment in making each of these decisions before the reporting entity can apply the recognition and measurement guidance of ASC 830.

- **“Mechanics of ASC 830”** — This section summarizes the processes for remeasuring foreign currency transactions into the functional currency and translating foreign currency statements into the reporting currency. While some judgment may be required (e.g., selecting exchange rates, assessing intra-entity transactions that are of a long-term investment nature), the accounting for foreign currency transactions and financial statement translation is largely a mechanical exercise once the functional currency has been determined.

### 1.3.1 Decision Points

The first step in applying the functional-currency approach under ASC 830 is to identify each distinct and separable operation within the consolidated group. While ASC 830 does not explicitly define “distinct and separable operation,” ASC 830-10-45-5 states:

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

ASC 830-10-45-5 highlights that the functional currency could be different for each distinct and separable operation, even if those operations are part of the same entity. Therefore, to correctly determine the functional currency under ASC 830, reporting entities must evaluate whether a single entity contains two or more distinct operations. See Chapter 2 for further guidance on determining distinct and separable operations.
Chapter 1 — Introduction

**Connecting the Dots**

ASC 830-10-45-5 clarifies that an entity should consider each distinct and separable operation of the reporting entity a separate “entity” when applying the requirements of ASC 830. Therefore, throughout this Roadmap, the terms “distinct and separable operation” and “entity” are used interchangeably.

After identifying the distinct and separable operations, the reporting entity must determine the functional currency of each one. This step is critical to the successful application of ASC 830 since the functional currency directly affects the identification and measurement of foreign currency transactions and translation of the financial statements (discussed in Section 1.3.2).

ASC 830 defines functional currency as “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.” ASC 830-10-45-6 further states that “the functional currency of an entity is, in principle, a matter of fact.” That is, the functional currency of an entity is not simply an election that the reporting entity makes but a determination that is made on the basis of facts.

It can be challenging to determine an entity’s functional currency, depending on the nature of the entity’s operations. Therefore, to help reporting entities determine the functional currency of their entities, ASC 830 provides the following indicators, which must be assessed both individually and collectively:

![Diagram of indicators](image)

Once an entity has determined the functional currency on the basis of evaluating the indicators above, it is generally rare that this currency would change in the future. ASC 830-10-45-7 indicates that there must be “significant changes in economic facts and circumstances” to justify changing an entity’s functional currency. However, ASC 830 also requires an entity to change its functional currency to the reporting currency of its immediate parent if the economy in which the entity operates becomes highly inflationary.

For more information about determining the functional currency, see Chapter 2. For a discussion of highly inflationary economies, see Chapter 7.
1.3.2 Mechanics of ASC 830

Under the functional-currency approach in ASC 830, the financial information of each distinct and separable operation of the reporting entity must be measured in its respective functional currency. Therefore, if an entity enters into a transaction that is denominated in a currency other than its functional currency (i.e., a foreign currency transaction), it must initially measure that transaction in its functional currency by using the exchange rate in effect when the transaction was recognized in its financial statements.

While all transactions are initially measured in the functional currency at the then-current exchange rate, the subsequent measurement (i.e., remeasurement) of a foreign currency transaction for monetary assets and liabilities is different from that for nonmonetary assets and liabilities, as illustrated below.

- Monetary assets and liabilities — The exchange rate in effect on the reporting date must be used to remeasure monetary assets and liabilities (e.g., receivables or payables in a foreign currency) at each reporting date in the functional currency. Therefore, fluctuations in the exchange rate between the date the foreign currency transaction was recognized and the date on which it is settled will cause the carrying amount of the monetary asset or liability to increase or decrease. That increase or decrease in the carrying amount of the asset or liability will result in a foreign currency transaction gain or loss (“transaction gain or loss”) in the period in which the exchange rate changes. With certain exceptions, transaction gains and losses should be presented in earnings in the period in which they arise.
• **Nonmonetary assets and liabilities** — The exchange rate that was in effect when the transaction was recognized (i.e., the historical exchange rate) must be used to remeasure, in the functional currency, nonmonetary assets and liabilities that are denominated in a foreign currency. Therefore, unlike the carrying amount of monetary assets and liabilities, the carrying amount of nonmonetary assets and liabilities will not increase or decrease as a result of fluctuations in exchange rates (and therefore no transaction gains and losses will arise). By using the historical exchange rate to remeasure nonmonetary assets and liabilities, an entity effectively achieves the same results it would have achieved if it had entered into the related transaction in its functional currency.

See Chapter 4 for more information about foreign currency transactions.

After all foreign currency transactions have been measured in the functional currency, the reporting entity must translate the financial statements of each foreign entity into the reporting currency. The purpose of the translation process is to state all amounts that are denominated or measured in a different currency in a single reporting currency (in a manner consistent with the primary objective of ASC 830 — see Section 1.1 above).

**Connecting the Dots**

While the requirements of ASC 830 for determining the functional currency and measuring all transactions in this currency apply to all distinct and separable operations within the reporting entity, the translation process is only relevant to foreign entities. This is because the financial statements of distinct and separable operations that are not foreign entities are already measured in the reporting currency.

The graphic below summarizes which exchange rates are used to translate each account type.

<table>
<thead>
<tr>
<th>Current</th>
<th>Historical</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Assets</td>
<td>• Common stock</td>
<td>• Revenues</td>
</tr>
<tr>
<td>• Liabilities</td>
<td>• Preferred stock</td>
<td>• Expenses</td>
</tr>
<tr>
<td></td>
<td>• APIC</td>
<td>• Gains</td>
</tr>
<tr>
<td></td>
<td>• Dividends</td>
<td>• Losses</td>
</tr>
<tr>
<td></td>
<td>• Beginning retained earnings</td>
<td>• Change in retained earnings from net income</td>
</tr>
</tbody>
</table>

**Connecting the Dots**

Although nonmonetary assets and liabilities are not remeasured in the functional currency each reporting period, they must still be translated into the reporting currency by using the current exchange rate. (See Section 1.3 for an explanation of the difference between remeasurement and translation.) The table below summarizes the exchange rates that are used in the remeasurement and translation processes for monetary and nonmonetary assets and liabilities.

<table>
<thead>
<tr>
<th>Account Type</th>
<th>Exchange Rate for Remeasurement</th>
<th>Exchange Rate for Translation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary assets and liabilities</td>
<td>Current exchange rate</td>
<td>Current exchange rate</td>
</tr>
<tr>
<td>Nonmonetary assets and liabilities</td>
<td>Historical exchange rate</td>
<td>Current exchange rate</td>
</tr>
</tbody>
</table>
Translation gains or losses, which result from the process of translating a foreign entity's financial statements into the reporting currency, are recorded in CTA, a separate component of OCI. See Chapter 5 for more information about the translation process.
Chapter 2 — Determining the Functional Currency

2.1 Chapter Overview

<table>
<thead>
<tr>
<th>ASC 830-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Functional Currency</td>
</tr>
<tr>
<td>45-2 The assets, liabilities, and operations of a foreign entity shall be measured using the functional currency of that entity. An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash.</td>
</tr>
</tbody>
</table>

To comply with the measurement and translation requirements in ASC 830, a reporting entity must identify the appropriate functional currency to use in measuring the financial position and operations of each of its foreign entities. A reporting entity may need to use significant judgment both in identifying foreign entities and in determining the “currency of the primary economic environment,” or functional currency, for each of these entities.

2.2 Definition of a Foreign Entity

<table>
<thead>
<tr>
<th>ASC 830-10-20 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Entity</td>
</tr>
<tr>
<td>An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:</td>
</tr>
<tr>
<td>a. Prepared in a currency other than the reporting currency of the reporting entity</td>
</tr>
<tr>
<td>b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.</td>
</tr>
</tbody>
</table>

The first step in the functional-currency approach is to determine which foreign entities make up the reporting entity. To be considered a foreign entity, an operation (or set of operations) should have its own financial statements or be able to produce such statements. Accordingly, a foreign entity most likely would have a management team that uses dedicated resources to run the entity's operations. The concept of “distinct and separable operations” is important to making this determination.

From a practical standpoint, a reporting entity may begin the determination of its distinct and separable operations by identifying each legal entity in its organizational structure. Next, the reporting entity must determine whether any of those legal entities have two or more distinct and separable operations (e.g., divisions, branches, product lines). If a legal entity has more than one distinct and separable operation,
a reporting entity would consider each operation a separate entity when applying the guidance in ASC 830. Otherwise, the legal entity itself would be considered the entity subject to ASC 830. Judgment must be used in the determination of whether a single legal entity has more than one separate and distinct operation, and the reporting entity must thoroughly understand how and where the legal entity conducts business.

**Connecting the Dots**

The term “foreign entity,” as used in ASC 830, refers to an entity that prepares its financial statements in a currency other than the reporting currency but does not refer to the entity’s geographical location. Therefore, an entity that is domiciled in the United States may meet the definition of a foreign entity under ASC 830. Similarly, an entity that is domiciled in a foreign country may not meet the definition of a foreign entity under ASC 830. Therefore, the reporting entity must determine the functional currency of each distinct and separable operation within the consolidated group, regardless of where that operation is geographically located. The identification of foreign entities is important, since ASC 830 requires that the financial statements of each foreign entity be translated into the reporting currency, as discussed in Section 1.2.

### 2.2.1 Identifying Distinct and Separable Operations

**ASC 830-10**

45-5 An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

55-6 In some instances, a foreign entity might have more than one distinct and separable operation. For example, a foreign entity might have one operation that sells parent-entity-produced products and another operation that manufactures and sells foreign-entity-produced products. If they are conducted in different economic environments, those two operations might have different functional currencies. Similarly, a single subsidiary of a financial institution might have relatively self-contained and integrated operations in each of several different countries. In those circumstances, each operation may be considered to be an entity as that term is used in this Subtopic, and, based on the facts and circumstances, each operation might have a different functional currency.

ASC 830-10-45-5 presents the notion of a “distinct and separable operation” but offers no definition of or qualifying criteria related to such an operation. Further, a distinct and separable operation may or may not meet the definition of a business in ASC 805-10. Thus, management will need to use judgment and consider all facts and circumstances in determining which operations are distinct and separable. However, the following factors, while not exhaustive, may indicate that an operation is distinct and separable for purposes of the functional-currency analysis:

- Separate assets and liabilities are specifically identifiable (i.e., not shared or commingled with other operations’ assets and liabilities).
- The operation can be managed separately and apart from other operations of the reporting entity.
- Accounting records for the operation could be produced.
Chapter 2 — Determining the Functional Currency

As noted previously, distinct and separable operations may be identified at a lower level than the legal entity itself. For instance, divisions or branches of the same legal entity (e.g., a subsidiary) may operate in different economic environments, in which case each may be considered a distinct and separable operation.

Example 2-1 — Distinct and Separable Operations

Bank IDB is an international development bank that conducts its operations through various currency pools. Each pool is self-contained and integrated within a particular currency. The activities of each pool are separate, distinct, and conducted in the economic environment of the foreign country. Within each pool, funds are raised in a single currency from borrowings, loan participations, capital, and accumulated earnings. These funds are for the most part held, invested, or loaned, and IDB may not convert a pool's currency (e.g., the JPY pool may not convert JPY into USD, GBP, etc.). Loans are denominated in the currency of the pool. Generally, pools do not convert currencies or engage in hedging currencies. For example, a loan denominated in JPY would be funded by JPY resources from the JPY pool. The loan and interest thereon would be repaid in JPY as well.

Under ASC 830, each pool should be viewed as a separate and distinct operation that should have its own functional currency. The pools described above operate in separate economic environments, and each has its own currency in which substantially all of its activities are executed. The pools do not hedge the local currency against the parent's functional currency. This is an important factor because it demonstrates that the pool operates in the local currency and does not peg its operations, or results thereof, to another currency by using derivatives. If one of the pools were to liquidate its investments in the cash or loans, IDB would be required to reclassify into income the amounts it has recognized in its cumulative translation adjustment related to those liquidated amounts, since the only holdings of the pools are financial instruments (i.e., financial assets and financial liabilities instead of operations).

Under ASC 830, reporting entities are not required to separate the accounting records of its operations if doing so is impracticable. Further, just because certain operations may be separable in some way (e.g., the operations have their own set of accounting records), the operations are not necessarily distinct and separable.

Reporting entities should carefully consider all facts and circumstances, as well as the factors discussed in Section 2.3, when determining whether an operation is distinct and separable. The following are some factors (not all-inclusive) indicating that operations may not be distinct and separable, even if separate accounting records are maintained:

- An entity's foreign division is solely responsible for manufacturing certain product lines for its parent.
- A holding company is essentially an extension of its parent (see Section 2.3.1 for additional considerations related to shell and holding companies).
- A subsidiary functions only as a foreign sales office for its parent.
- Individual retail stores are managed centrally.
- A foreign subsidiary operates only as the treasury function for its parent.
Example 2-2 — Operations That Are Not Distinct and Separable

The overall conclusion from Example 2-1 would be different if Bank IDB engaged in (1) foreign-currency-hedge strategies, (2) other means of converting a particular foreign currency into the parent's functional currency, or (3) activities to convert a pool's currency into the currency of another country, such as USD or JPY. In such cases, the operations of the pools would be considered shell operations of IDB (i.e., extensions of IDB) and therefore their functional currency would be the parent's reporting currency. See Section 2.3.1 for considerations related to shell and holding companies.

2.3 Definition of Functional Currency and Indicators

ASC 830-10

Identifying a Foreign Entity’s Functional Currency

45-3 It is neither possible nor desirable to provide unequivocal criteria to identify the functional currency of foreign entities under all possible facts and circumstances and still fulfill the objectives of foreign currency translation. Arbitrary rules that might dictate the identification of the functional currency in each case would accomplish a degree of superficial uniformity but, in the process, might diminish the relevance and reliability of the resulting information.

45-4 Multinational reporting entities may consist of entities operating in a number of economic environments and dealing in a number of foreign currencies. All foreign operations are not alike. To fulfill the objectives in paragraph 830-10-10-2, it is necessary to recognize at least two broad classes of foreign operations:

a. In the first class are foreign operations that are relatively self-contained and integrated within a particular country or economic environment. The day-to-day operations are not dependent on the economic environment of the parent's functional currency; the foreign operation primarily generates and expends foreign currency. The foreign currency net cash flows that it generates may be reinvested or converted and distributed to the parent. For this class, the foreign currency is the functional currency.

b. In the second class are foreign operations that are primarily a direct and integral component or extension of the parent entity's operations. Significant assets may be acquired from the parent entity or otherwise by expending dollars and, similarly, the sale of assets may generate dollars that are available to the parent. Financing is primarily by the parent or otherwise from dollar sources. In other words, the day-to-day operations are dependent on the economic environment of the parent's currency, and the changes in the foreign entity's individual assets and liabilities impact directly on the cash flows of the parent entity in the parent's currency. For this class, the dollar is the functional currency.

45-5 An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

45-6 The functional currency of an entity is, in principle, a matter of fact. In some cases, the facts will clearly identify the functional currency; in other cases they will not. For example, if a foreign entity conducts significant amounts of business in two or more currencies, the functional currency might not be clearly identifiable. In those instances, the economic facts and circumstances pertaining to a particular foreign operation shall be assessed in relation to the stated objectives for foreign currency translation (see paragraphs 830-10-10-1 through 10-2). Management's judgment will be required to determine the functional currency in which financial results and relationships are measured with the greatest degree of relevance and reliability.
Chapter 2 — Determining the Functional Currency

Once the distinct and separable operations have been identified, the next step is to determine the “currency of the primary economic environment in which the [distinct and separable operation] operates.” An entity may be required to use significant judgment in making this determination, depending on the nature of the operation being evaluated. The following are two scenarios illustrating the determination of the functional currency:

1. Entity A, a subsidiary of a U.S. parent, is an operating company located in France that is relatively autonomous. Entity A conducts all of its operations in France, and all of its transactions are denominated in EUR.

2. Entity B, a subsidiary of a U.S. parent, is a holding company located in Germany and obtains a loan denominated in USD from its U.S. parent. In addition, B borrows additional funds denominated in EUR from an unrelated third party and invests the entire amount, denominated in EUR, in Entity C, an operating company also located in Germany. Entity B intends to use dividends received from its investment in C to remit dividends to the parent in USD.

In the first scenario, the determination of the functional currency is relatively straightforward: A’s functional currency is the EUR. However, in the second scenario, it is not clear whether B’s functional currency is USD or the EUR. Management would need to use judgment in determining B’s functional currency in the second scenario.

Further, it should not be assumed that the functional currency is either that of the parent or that of the jurisdiction in which the distinct and separable operation operates (i.e., the local currency). Management may also conclude, on the basis of the facts and circumstances, that the functional currency is that of another jurisdiction (although such a conclusion is not as common).

In determining the appropriate functional currency, management should consider each of the economic factors in ASC 830-10-55 and thoroughly document the conclusions reached.

**ASC 830-10**

**55-3** The following provides guidance for determination of the functional currency. The economic factors cited here, and possibly others, should be considered both individually and collectively when determining the functional currency.

**55-4** This general guidance presents indicators of facts to be considered in identifying the functional currency. In those instances in which the indicators are mixed and the functional currency is not obvious, management’s judgment will be required to determine the functional currency that most faithfully portrays the economic results of the entity’s operations and thereby best achieves the objectives of foreign currency translation set forth in paragraph 830-10-10-2. Management is in the best position to obtain the pertinent facts and weigh their relative importance in determining the functional currency for each operation. It is important to recognize that management’s judgment is essential and paramount in this determination, provided only that it is not contradicted by the facts.
The following salient economic factors, and possibly others, should be considered both individually and collectively when determining the functional currency:

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

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

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

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

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

f. Intra-entity transactions and arrangements indicators, for example:
   1. Foreign currency. There is a low volume of intra-entity transactions and there is not an extensive interrelationship between the operations of the foreign entity and the parent entity. However, the foreign entity's operations may rely on the parent's or affiliates' competitive advantages, such as patents and trademarks.
   2. Parent's currency. There is a high volume of intra-entity transactions and there is an extensive interrelationship between the operations of the foreign entity and the parent entity. Additionally, the parent's currency generally would be the functional currency if the foreign entity is a device or shell corporation for holding investments, obligations, intangible assets, and so forth, that could readily be carried on the parent's or an affiliate's books.
In some instances, a foreign entity might have more than one distinct and separable operation. For example, a foreign entity might have one operation that sells parent-entity-produced products and another operation that manufactures and sells foreign-entity-produced products. If they are conducted in different economic environments, those two operations might have different functional currencies. Similarly, a single subsidiary of a financial institution might have relatively self-contained and integrated operations in each of several different countries. In those circumstances, each operation may be considered to be an entity as that term is used in this Subtopic, and, based on the facts and circumstances, each operation might have a different functional currency.

Foreign investments that are consolidated or accounted for by the equity method are controlled by or subject to significant influence by the parent entity. Likewise, the parent's currency is often used for measurements, assessments, evaluations, projections, and so forth, pertaining to foreign investments as part of the management decision-making process. Such management control, decisions, and resultant actions may reflect, indicate, or create economic facts and circumstances. However, the exercise of significant management control and the use of the parent's currency for decision-making purposes do not determine, per se, that the parent's currency is the functional currency for foreign operations.

ASC 830 does not address how the above economic factors should be applied (e.g., weightings or hierarchy may differ for certain factors) but states that these “factors, and possibly others, should be considered both individually and collectively when determining the functional currency.”

However, because changes in functional currency are expected to be infrequent (see Section 2.4), management should place greater emphasis on long-term considerations related to each factor than it does on short-term considerations. For example, start-up operations may receive significant financing from the parent in the parent's functional currency but ultimately plan to operate primarily in a foreign economic environment. In such cases, the facts and circumstances may indicate that, while the start-up operation's financing was in the currency of its parent in the short term, the start-up operation may eventually operate primarily in the foreign economic environment. Therefore, consideration of the factors above would most likely lead to a conclusion that the start-up operation's functional currency is, in fact, different from the parent's.

**Connecting the Dots**

The parent company's exercise of control (or significant influence) is not a factor in the determination of functional currency. Rather, joint ventures, equity method investments, and consolidated variable interest entities are all subject to the same analysis and, depending on the facts and circumstances, may or may not have the same functional currency as their parent entities.
Company X, which is incorporated in the United States, is a subsidiary of a U.S.-based parent whose reporting currency is USD. Company X maintains operations, including marketing and manufacturing, in several countries. Belgium is the predominant manufacturing location, and Canada is the predominant research and development location. In addition, X has operations in two other countries. Management has determined that none of X's foreign operations are distinct and separable for various reasons, including their inability to produce stand-alone accounting records and their central management by X. Therefore, the functional currency has been determined for X as a whole.

Management of X uses USD when preparing its company-wide budget and internal reports. Salaries and other general expenses are paid in the local currencies of the countries in which X operates. Sales are invoiced in USD, but local customers frequently pay in the local currency at the current exchange rate. All intercompany sales are denominated and paid in USD. About 80 percent of X's borrowings are denominated in USD.

Several of the indicators in ASC 830-10-55-5 demonstrate that X's functional currency is USD. Because X transacts business in several countries, one local currency is not considered more dominant than another. Sales invoicing, financing, and intercompany transactions are predominantly in USD, and this currency is dominant in management's budgeting and pricing process. While selling and general expenses are paid in other currencies, doing so is a function of X's business transactions in those countries. For example, a worker in the Belgian manufacturing plant would expect his or her salary to be paid in the local currency (i.e., EUR), not in USD. Further, net cash flows appear to be in USD.
Chapter 2 — Determining the Functional Currency

Example 2-4 — Evaluating the Factors Related to Determining Functional Currency — Subsidiaries With Different Functional Currencies

Company Z, a U.K.-based entity whose functional currency is the GBP, has two operating subsidiaries, Company A and Company B, which are distinct and separable operations under ASC 830. Both A and B obtain financing from Z, which is denominated in GBP (i.e., neither subsidiary maintains third-party debt). See Example 2-5 for discussion related to B.

Company A is located in Spain, where most of its products are manufactured and sold. Sales prices charged by A are denominated in EUR and determined on the basis of local conditions (i.e., market competition or government regulations in Spain). Similarly, selling and administrative expenses are paid in EUR. Any excess cash flows are retained by A and reinvested in the Spain-based operations. A does not have intercompany transactions other than payments made to the parent entity in GBP in connection with its outstanding intercompany debt, which is not material to A’s balance sheet.

We believe that A’s functional currency is the EUR. Although financing is entirely in GBP, the majority of the remaining economic indicators are in EUR. Sales are invoiced, selling and general expenses are paid in EUR, and excess cash flows are retained by A and reinvested in the Spanish operations.
Example 2-5 — Evaluating the Factors Related to Determining Functional Currency — Subsidiaries With Different Functional Currencies

Company B is located in Mexico, but its products are manufactured primarily in the United Kingdom and purchased from Z at a transfer price set to cover both production costs and research and development; these intercompany sales are invoiced in GBP. Sales prices charged by B are denominated in MXN and determined on the basis of local conditions (i.e., market competition or government regulations in Mexico). Similarly, selling and administrative expenses are paid in local currency. Any excess cash flows generated by B are distributed to and invested by Z in the United Kingdom.

We believe that B's functional currency is GBP. Financing is entirely in GBP, and intra-entity transactions, which include significant inventory transfers, are predominantly in GBP. Further, excess cash flows are repatriated to the United Kingdom, where they are invested by the parent entity. Although sales are invoiced and selling and general expenses are paid in MXN, doing so is a function of conducting business in Mexico, and it appears that these are the only cash flows not denominated in GBP. In this case, group management most likely views B as a local sales branch integral to the parent.
Example 2-6 — Functional Currency of a Start-Up Operation

Newco is a U.K.-based, newly formed, wholly owned subsidiary of Company A, a U.S.-based entity whose functional currency is USD. Because of a series of legal transactions associated with the creation of Newco, cash received from A as part of initial equity financing and a note due from another subsidiary of A (the “note”) are Newco’s only assets, both of which are denominated in USD; it has no significant liabilities. Newco does not currently have any operational activities or any employees of its own since A’s employees currently manage and operate the entity. In considering Newco’s functional currency, A’s management focuses on longer-term considerations rather than shorter-term considerations, including intentions for Newco to (1) establish local manufacturing operations, (2) recruit and hire locally based management and a general workforce, and (3) create a sales force to develop a local customer base. In addition, management’s intention is for Newco to retain the initial cash financing and retain and accumulate the repaid principal and interest earned on the note (all denominated in USD). The accumulated USD-denominated funds will be used to fund the start-up operations and consummate potential future acquisitions of U.K.-based entities. Management has no intention to repatriate any funds held by Newco to A.

On the basis of Newco’s current structure and operations, it seems to have the same functional currency as its parent (i.e., USD). However, management’s long-term intention is for Newco to act as a distinct and separate entity within the United Kingdom. Newco, therefore, will have the characteristics of an entity that is integrated into a particular economic environment (i.e., the United Kingdom) and that has a currency different from the one that currently represents most of Newco’s operations. Although intra-entity transactions are denominated in USD, they are limited to payments received related to the note. Upon formation, therefore, Newco’s functional currency is GBP rather than USD.

2.3.1 Considerations for Shell and Holding Companies

Although ASC 830 does not assign weight to or provide a specific hierarchy for the indicators discussed above, it indicates that if a shell or holding company was formed primarily to hold assets or liabilities (e.g., investments, debt, intangible assets) that could “readily be carried on the parent’s or an affiliate’s books,” the functional currency for that shell or holding company would generally be that of its immediate parent. This could be the case, for example, when a holding company is established to conduct a narrow transaction or set of transactions (e.g., borrowing) that could have easily been performed by the parent. In listing factors that may indicate that the parent’s currency should be the entity’s functional currency, ASC 830-10-55-5(f)(2) states:

There is a high volume of intra-entity transactions and there is an extensive interrelationship between the operations of the foreign entity and the parent entity. Additionally, the parent’s currency generally would be the functional currency if the foreign entity is a device or shell corporation for holding investments, obligations, intangible assets, and so forth, that could readily be carried on the parent’s or an affiliate’s books.
Connecting the Dots

There may be cases in which the parent entity itself is a holding company (e.g., when a company is trying to access a particular market, such as the U.S. market, a holding company may be established to facilitate market access). There is no explicit guidance on how to determine the functional currency of such entities. In such circumstances, entities are encouraged to consult with their accounting advisers.

Example 2-7 — Functional Currency for Holding Companies

Company A, which has identified the USD as its functional currency, establishes two holding companies, Company B and Company C. Company B is incorporated in the United States, and C is incorporated in the United Kingdom. Company A loans 5 million GBP (£) to each company; B and C both record the transaction as an intercompany payable. Company B has no other assets, liabilities, or operations besides the cash received and the corresponding intercompany payable. In addition, C borrows an additional £2 million from an unrelated third party; A guarantees this loan. Company C invests the entire £7 million in Company D, an operating company in the United Kingdom, and intends to use dividends received from its investment in D to repay the loan to the third party.

The functional currency of B should be USD, the same functional currency as that of its parent company. Although B's loan transaction results in a payable denominated in a foreign currency, it is a shell company. It has no substantive operations of its own and is not conducting any operations that the parent could not otherwise conduct itself. Therefore, its functional currency should be USD.

Company C also appears to be a shell company. However, C must consider additional indicators in determining its functional currency; these indicators demonstrate that C is "integrated within a particular country or economic environment." Specifically, C is incorporated in the United Kingdom and has an investment in a substantive operating company that is also incorporated in the United Kingdom; has borrowed money from a third party that is denominated in GBP instead of USD; and intends to repay its third-party loan by using dividends from its investment in D. Thus, C's functional currency appears to be GBP.

2.4 Change in Functional Currency

ASC 830-10

Changes in the Functional Currency

45-7 Once the functional currency for a foreign entity is determined, that determination shall be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. Previously issued financial statements shall not be restated for any change in the functional currency.

45-8 See paragraph 250-10-45-1 for guidance on adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring. Paragraphs 830-10-45-15 through 45-16 discuss changes related to highly inflationary economies.

Functional Currency Changes from Reporting Currency to Foreign Currency

45-9 If the functional currency changes from the reporting currency to a foreign currency, the adjustment attributable to current-rate translation of nonmonetary assets as of the date of the change shall be reported in other comprehensive income.
If the functional currency changes from a foreign currency to the reporting currency, translation adjustments for prior periods shall not be removed from equity and the translated amounts for nonmonetary assets at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods. This guidance shall be used also to account for a change in functional currency from the foreign currency to the reporting currency when an economy becomes highly inflationary.

ASC 830-10-45-7 indicates that there must be “significant changes in economic facts and circumstances” to justify a change in functional currency. Except when an economy is identified as highly inflationary (see Chapter 7), ASC 830 does not define or provide examples related to what constitutes a significant change in facts and circumstances. An entity must therefore use judgment in determining whether significant changes in facts and circumstances have occurred. However, such changes are generally expected to be rare.

**Connecting the Dots**

Changes in the functional currency may result from one-time transactions, such as a merger or acquisition, or from a longer-term shift in an entity’s operations. Regardless of the reason, it is important that management carefully consider whether such an event is significant enough to warrant a change in the functional currency. Because ASC 830 does not provide guidance on how to determine whether a change is “significant,” preparers may find it helpful to compare the indicators before and after the change in making the determination. Entities are encouraged to consult with their accounting advisers in such situations.
Example 2-8 — Significant Changes in Facts and Circumstances That Justify a Change in Functional Currency

Company H, located in Ireland, is a wholly owned subsidiary of Company K, whose functional currency is USD. Company H has identified the EUR as its functional currency because, among other indicators, its sales and purchases, as well as its labor costs, have primarily been denominated in this currency. During the fourth quarter, H's operations begin to change. The sales composition of H changes because it loses some sizable contracts and gains some significant new contracts. Company K begins using H's manufacturing facility to complete its sales orders. Because more than 80 percent of H's sales will come from K's operations, H will no longer need to generate its own sales; therefore, H terminates its sales force. K builds a new facility to produce the materials needed in its manufacturing processes. As of the end of the fiscal year, H begins receiving all materials from K instead of from outside vendors. On the basis of the changes in its business, H expects cash inflows and outflows, except for wages, to be primarily denominated in USD.

These circumstances collectively justify a change in H's functional currency from EUR to USD. For example, the denomination of revenues has changed from primarily EUR to USD. This change does not appear to be temporary since H has terminated its sales force. In addition, the denomination of cash outflows for materials also has changed to USD. Because K has built a new facility to make these materials, this change does not appear to be temporary either. Further, the philosophy behind H's operations has changed: in K's overall operating strategy, H has changed from a self-supporting, stand-alone operating company to a manufacturing facility of K.

<table>
<thead>
<tr>
<th>Changes</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Conversion to 80% sales made in USD.</td>
<td>Change in functional currency to USD.</td>
</tr>
<tr>
<td>• Utilization of facilities for USD-based sales orders.</td>
<td></td>
</tr>
<tr>
<td>• Termination of local sales force.</td>
<td></td>
</tr>
<tr>
<td>• Majority of cash outflows now in USD.</td>
<td></td>
</tr>
</tbody>
</table>
Example 2-9 — Impact of Significant Borrowings on Determination of Functional Currency

Company O's functional currency is USD, and O uses the equity method to account for its 43 percent investment in Company M, a Mexican company whose functional currency is the MXN. During the current year, M enters into a $200 million third-party borrowing denominated in USD. Most of M's operations, labor costs, and purchases are denominated in MXN.

Despite the significant borrowing denominated in USD, it is not appropriate for M to change its functional currency from MXN to USD. Because most of M's operations, sales, purchases, and labor cost are denominated in MXN, M should continue using the MXN as its functional currency. Although a large third-party financing in the parent's functional currency may constitute some evidence of a change in the functional currency from MXN to USD, there is insufficient evidence of such a change in this example.

Example 2-10 — Effects of an Acquisition on Functional Currency

Company W is a manufacturing entity whose primary operations (e.g., headquarters, manufacturing operations, majority of sales contracts) are located in the United States and whose functional currency is USD. Company W is acquired by Company L, a similar manufacturing entity that is based in Luxembourg and whose functional currency is the EUR, as part of L's efforts to expand into the North American market. L plans to cease manufacturing operations in the United States, since it has adequate capacity within its existing facilities in Europe, and to manage W's operations from its European headquarters in Luxembourg. These changes result in the conversion of W into a foreign sales office for L. Therefore, W's functional currency changes to the EUR when it is acquired by L.

If significant changes had not been made to W's operations after the acquisition, W's functional currency most likely would have remained the USD.
SEC Considerations

The SEC’s *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, released by the Division of Corporation Finance (the “Division”), provides an additional example in which a change in functional currency may be appropriate. This guidance states that “[r]egistrants with foreign operations in economies that have recently experienced economic turmoil should evaluate whether significant changes in economic facts and circumstances have occurred that warrant reconsideration of their functional currencies.” The Division warns, however, that it may be difficult to conclude that “currency exchange rate fluctuations alone would cause a self-contained foreign operation to become an extension of the parent company.” Regardless of the underlying reason for the change in functional currency, the Division suggests that, although ASC 830 does not require them to do so, “[r]egistrants should consider the need to disclose the nature and timing of the change, the actual and reasonably likely effects of the change, and economic facts and circumstances that led management to conclude that the change was appropriate. The effects of those underlying economic facts and circumstances on the registrant’s business should also be discussed in MD&A.”

2.4.1 Determining When to Change the Functional Currency

In accordance with ASC 830-10-45-7, a change in functional currency should be reported as of the date on which it is determined that “significant changes in economic facts and circumstances” have occurred. Although such a change could occur on any date during the year, it is acceptable to use a date at the beginning of the most recent reporting/accounting period.

2.4.2 Accounting for a Change in the Functional Currency

ASC 250-10-45-1 states that the “[a]doption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring” is not considered a change in accounting principle. Because a change in functional currency is necessitated by a significant change in facts and circumstances that are “clearly different in substance from those previously occurring,” such a change does not meet the definition of a change in accounting principle and therefore should not be accounted for as such (i.e., previously issued financial statements should not be restated).

The accounting effects of a change in functional currency depend on (1) the type of change being made (e.g., foreign currency (likely the local currency) to reporting currency or reporting currency to foreign currency) and (2) the nature of the assets or liabilities being restated (i.e., monetary or nonmonetary). The following table summarizes the consolidated accounting treatment of a change in functional
currency as of the first day of a reporting period and assumes that the foreign entity is a direct subsidiary of the parent:

### Effect of Changes in Functional Currency on the Consolidated Financial Statements

<table>
<thead>
<tr>
<th>Type of Change</th>
<th>Nonmonetary Assets and Liabilities</th>
<th>Monetary Assets and Liabilities</th>
<th>Effect on CTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reporting currency to foreign currency¹</td>
<td>Translate at the rate in effect on the date of change. Causes a difference between historical carrying value (based on rate at time of asset or liability's inception) and new carrying value (based on current rate).</td>
<td>Translate at the rate in effect on the date of change. Causes no difference between historical carrying value and new carrying value.</td>
<td>Difference between historical basis of nonmonetary assets and liabilities and new basis is recorded in CTA.</td>
</tr>
<tr>
<td>Foreign currency to reporting currency</td>
<td>Translated balances at the end of the prior period become the new accounting basis.</td>
<td>Translated balances at the end of the prior period become the new accounting basis.</td>
<td>No effect.</td>
</tr>
<tr>
<td>Foreign currency to other foreign currency</td>
<td>Remeasure into the new functional currency at the rate in effect on the date of the asset or liability's inception. Then translate into reporting currency based on current exchange rate.</td>
<td>Remeasure into the new functional currency at the rate in effect on the date of change. Then translate into reporting currency based on current exchange rates.</td>
<td>Difference between historical basis of nonmonetary assets and liabilities and new basis is recorded in CTA.</td>
</tr>
</tbody>
</table>

In all scenarios, the rate on the date of change becomes the historical rate at which nonmonetary assets and liabilities are translated in subsequent years. Previously recorded CTA balances are not reversed.

For additional information on accounting for monetary and nonmonetary assets and liabilities, see Chapter 4.

¹ This guidance does not apply to situations in which an entity is changing its functional currency from the reporting currency to a foreign currency (likely the local currency) because an economy ceases to be highly inflationary. See Chapter 7 for guidance on such situations and Example 7-6 for an illustration of the differences.
Example 2-11 — Accounting for a Change in Functional Currency

The table below represents the accounting records of Company X, a foreign entity whose parent company's reporting currency is USD. As a result of significant change in facts and circumstances, X's functional currency has changed from USD (its reporting currency) to EUR (its local currency). The change occurs on January 1, 20X5. This example assumes the following:

- All nonmonetary assets and liabilities arise on the same date, January 1, 20X0, when the EUR-to-USD exchange rate is 1 to 2. Assume no depreciation is taken on the PP&E.
- Company X maintains its books and records in EUR, its local currency.
- The EUR-to-USD exchange rate on the date of the change in functional currency is 1 to 1.5.
- The reporting currency of the consolidated entity is USD.

<table>
<thead>
<tr>
<th>Asset/Liability</th>
<th>Local Currency Balance Before Change (EUR)</th>
<th>Remeasurement Before Change* (USD)</th>
<th>Translation Into Reporting Currency (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>€ 500</td>
<td>$ 750</td>
<td>$ 750</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>2,000</td>
<td>4,000*</td>
<td>3,000*</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>1,500</td>
<td>2,250</td>
<td>2,250</td>
</tr>
<tr>
<td>Equity</td>
<td>1,000</td>
<td>2,500</td>
<td>1,500</td>
</tr>
</tbody>
</table>

* The difference between the carrying value of the PP&E at the historical exchange rate (i.e., 1 to 2) and that at the current exchange rate (i.e., 1 to 1.5) is recorded as a CTA.

Connecting the Dots

Considerations When Functional Currency Changes

A change in functional currency can have a number of effects on an entity, a few examples of which are depicted above. An entity should carefully consider the impact of the change in functional currency on all account balances. For example, the lower-of-cost-or-market analysis required by ASC 330-10 would have to be performed in the new functional currency. In addition, an entity should revisit its various investing and hedging positions to determine whether changes in methods or strategies are warranted.
2.5 Change in Reporting Currency

ASC 830 does not specifically address a change in reporting currency (i.e., the currency in which the financial statements are presented). The FASB staff has said that it would permit some sort of “convenience translation” (i.e., the translation of an entity’s financial statements from its reporting currency into another currency for the convenience of readers) if the change in reporting currency was necessitated by a change in the parent’s functional currency. However, the FASB staff prefers a restatement of the prior periods as though the information originally had been presented in the new reporting currency.

SEC Considerations

In accordance with SEC Regulation S-X, Rule 3-20(e), if an SEC registrant changes its reporting currency, it is required to “recast its financial statements as if the newly adopted currency had been used since at least the earliest period presented in the filing.” In addition, the registrant should disclose the “decision to change and the reason for the change in the reporting currency” in the period in which the change occurs.
Chapter 3 — Exchange Rates

3.1 Chapter Overview

Foreign currency transactions must be remeasured into an entity’s functional currency in accordance with ASC 830-20 on accounting for foreign currency transactions, as described in Chapter 4.

After the remeasurement process, an entity must use the current-rate method to translate its financial statements into its parent’s reporting currency. See Chapter 5 for further discussion related to the translation of foreign entity financial statements.

While ASC 830 provides some guidance on which exchange rates are to be used, it may not always be clear that a particular exchange rate is appropriate and an entity may need to use judgment in making this determination. For example, an entity may often consider economic, market, and political circumstances. This chapter discusses the selection and use of appropriate exchange rates, both as discussed in ASC 830 and in various other situations.

3.2 Selecting Exchange Rates

ASC 830 defines an exchange rate 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.”

3.2.1 Current Rate Versus Average Rate

Foreign entities are required to use the current exchange rate\(^1\) to translate their financial statements into the reporting currency of the reporting entity. ASC 830-30-45-3 describes such translation as follows:

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

a. For assets and liabilities, the exchange rate at the balance sheet date shall be used.

b. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used.

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

---

\(^1\) ASC 830-30-45-4 defines the current exchange rate as “the rate as of the end of the period covered by the financial statements or as of the dates of recognition in those statements in the case of revenues, expenses, gains, and losses.”
Chapter 3 — Exchange Rates

The following table summarizes the translation exchange rates to use for various types of accounts:

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Exchange Rate for Translation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets and liabilities</td>
<td>Current exchange rate in effect on the balance sheet date</td>
</tr>
<tr>
<td>Equity (excluding change in retained earnings due to current-year net income)</td>
<td>Historical exchange rates</td>
</tr>
<tr>
<td>Change in retained earnings — current-year net income</td>
<td>Weighted-average exchange rate for the period</td>
</tr>
<tr>
<td>Income statement accounts</td>
<td>Weighted-average exchange rate for the period</td>
</tr>
</tbody>
</table>

As indicated above, assets and liabilities should be translated at the exchange rate on the balance sheet date. However, although ASC 830 states that revenues, expenses, gains, losses, and accounting allocations (e.g., depreciation, cost of sales, and amortization of deferred revenues and expenses) should be translated by using the exchange rate on each date of recognition in earnings during the period, a weighted-average rate generally may be appropriate, as discussed further below. Further, although ASC 830 does not provide guidance on which rate should be used to translate a foreign entity's equity accounts, we believe that it would be appropriate to translate equity accounts at historical rates (as indicated in the table above), except changes to retained earnings for current-period net income, which would be translated at the weighted-average rate (discussed further below). When historical exchange rates are used, capital transactions, such as contributions, investments, and dividends, would be translated at the rate on the date of recognition.

Because of the recognition requirements for certain types of income statement items, translation at the exchange rate on each date of recognition may prove difficult or burdensome. ASC 830 therefore provides an expedient under which an entity uses an appropriate rate that is expected to yield a result similar to that achieved by using the exchange rate on each date of recognition.

ASC 830-10

55-10 Literal application of the standards in this Subtopic might require a degree of detail in record keeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Accordingly, it is acceptable to use averages or other methods of approximation. For example, because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Likewise, the use of other time- and effort-saving methods to approximate the results of detailed calculations is permitted.

55-11 Average rates used shall be appropriately weighted by the volume of functional currency transactions occurring during the accounting period. For example, to translate revenue and expense accounts for an annual period, individual revenue and expense accounts for each quarter or month may be translated at that quarter’s or that month’s average rate. The translated amounts for each quarter or month should then be combined for the annual totals.
Period-appropriate, weighted-average exchange rates are most commonly used for income statement items that have recognition patterns throughout the period. A monthly, quarterly, or annual rate should be determined and used to translate monthly, quarterly, or annual income statements, respectively. Monthly or quarterly income statements translated at the relevant averaged rates would then be added together, as appropriate, to arrive at the year-end statement. An entity should carefully determine when it is appropriate to use averaging to translate income statement items. For example, a weighted-average rate may not be appropriate for items that are tied to discrete events, such as certain impairments or write-offs. In that case, the exchange rate from that specific date would be required.

**Connecting the Dots**

When applying weighted-average exchange rates to income statement items, an entity should calculate the “weighting” appropriately by considering the pattern of recognition. Developing an appropriate weighted-average exchange rate may include consideration of complexities that are specific to the foreign entity's operations, including seasonality, multiple product lines with various recognition patterns, or uneven expense recognition. An entity should also consider volatility in foreign currency exchange rates. Further, an entity has flexibility to determine the appropriate rate given that “other [appropriate] methods of approximation” may also be used for translating income statement items. For these reasons, consultation with accounting advisers is encouraged if an entity needs to use significant judgment in calculating a weighted-average exchange rate or applying another method of approximation.

### 3.2.2 Multiple Exchange Rates

When an official exchange rate coexists with an unofficial exchange rate that also is legal for currency conversions, a parallel or dual exchange-rate situation exists. In such circumstances, if it can be reasonably demonstrated that transactions have been or could have been legally settled at the unofficial rate (including currency exchanges for dividend or profit repatriations), it may be appropriate to use the unofficial rate for translation or remeasurement.

**ASC 830-30**

| 45-6 | In the absence of unusual circumstances, the exchange rate applicable to conversion of a currency for purposes of dividend remittances shall be used to translate foreign currency statements. |

Although not codified, paragraph 138 of the Basis for Conclusions of FASB Statement 52 (superseded) is helpful for understanding this concept. The FASB concluded that in the absence of unusual circumstances, an entity should use the dividend remittance rate to translate foreign financial statements if multiple exchange rates exist. This rate was considered more meaningful because cash flows to the reporting entity can only occur at this rate and realization of the net investment depends on the cash flows from that foreign entity.

Unusual circumstances in which an entity may be permitted to use the market exchange rate in translating the financial statements of a foreign subsidiary could include (1) a history of obtaining the market exchange rate for remittances of earnings or dividends distributed outside the foreign country and (2) the ability to source funds at the market exchange rate if there is no question of asset impairment.
Chapter 3 — Exchange Rates

Example 3-1 — Multiple Exchange Rates

Company A, a U.S. company whose fiscal year ended on June 30, 20X1, has a foreign subsidiary, Company B. On June 30, 20X1, an official exchange rate existed for conversion of the foreign currency to USD. Because of foreign currency restrictions, however, few exchanges were made at that rate. About 80 percent of B’s earnings for the year ended June 30, 20X1, were converted to USD (and remitted to A) at a rate substantially lower than the official rate (the unofficial rate). The unofficial exchange rate was determined by the local broker making the conversion and by an informal foreign exchange market that existed in the foreign country. Although exchange restrictions existed, B’s remittance transactions at the unofficial rate were not illegal transactions. In this example, the unofficial rate should be used for translation or remeasurement.

Furthermore, the rate used must be a legal rate (see Section 3.2.4).

3.2.3 Preference or Penalty Rates

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

Regulation of foreign exchange markets by foreign governments may dictate the exchange rates to be used to convert local currency into other currencies. Those rates are set by the foreign governments, rather than the market exchange rate, and may be either favorable (preferential rate) or unfavorable (penalty rate) compared with the rate that applies to other transactions. For example, a foreign government may establish a rate of LC5:$1 for certain goods it deems essential while the prevailing market rate may be LC10:$1.

An entity should carefully consider whether the rate to be used for remeasuring monetary items is the preference or penalty rate and should appropriately support use of either rate for remeasuring monetary items to demonstrate that conversion of the monetary items at that rate could have been achieved. If use of a preference or penalty rate cannot be supported, the entity should use the rate applicable to dividend remittances.

3.2.4 Black Market Rates

In certain countries, unofficial exchange rates may develop as a result of restrictive foreign exchange controls. Such rates are referred to as “black market exchange rates” or “black market rates” since they are not legally recognized. Accordingly, use of black market rates is not appropriate for either remeasurement or translation purposes under ASC 830.
This conclusion is consistent with discussion at the March 4, 2003, meeting of the AICPA SEC Regulations Committee's International Practices Task Force\(^2\) (IPTF or "the Task Force") and was later reaffirmed in the highlights of the November 25, 2008, meeting concerning the appropriate foreign exchange rates to be used for remeasurement and translation purposes. The meeting highlights state, in part:

The Task Force believes that . . . US GAAP does not permit the use of a black market exchange rate since such a rate is not objective or determinable. Instead, individual transactions should be translated at either the parallel rate, or the official exchange rate based on the facts and circumstances, and if there are more than one official exchange rate depending on the transaction (e.g., dividend remittances), then the appropriate exchange rate should be used.

### 3.2.5 Lack of Exchangeability

This concept is illustrated in the following example from ASC 830-30-55-1 (previously EITF Topic D-12).

#### Example 1: Exchange Rate When Exchangeability Is Lacking Temporarily

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

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

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

In a manner consistent with ASC 830-20-30-2 and the example above, if there is a temporary lack of exchangeability between two currencies as of the transaction or balance sheet date, an entity should use the first subsequent rate at which exchanges could be made.

\(^2\) The IPTF is a task force of the SEC Regulations Committee that focuses on emerging international technical accounting and reporting issues related to SEC rules and regulations. According to the IPTF's [Web site](https://www.accounting.org), "[t]he objective of the IPTF is to protect investors by improving the quality of public company financial reporting by identifying, discussing, and facilitating resolution of issues relating to the promulgation, interpretation, and application of SEC rules, regulations, and policies with the assistance of the SEC staff and communicating those matters publicly on a timely basis."
Chapter 3 — Exchange Rates

The IPTF discussed what was intended by the term “first subsequent rate” at its January 14, 2001, meeting. The meeting highlights state:

The Task Force did not believe that this guidance should be read literally as the “first” exchange transaction. Certain members of the Task Force informally discussed this issue with the staff of the FASB, who indicated their view that the guidance in FAS 52 was not intended to be literally the “first” transaction.

Accordingly, we believe that an entity should use judgment in determining the appropriate exchange rate to use. In making this determination, the entity should consider all factors available, including the volume, size, and types of transactions. Furthermore, the absence of observable large transactions would not necessarily be indicative of a continued temporary lack of exchangeability.

3.3 Changes in Exchange Rates

<table>
<thead>
<tr>
<th>ASC 830-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-16 A reporting entity's financial statements shall not be adjusted for a rate change that occurs after the date of the reporting entity's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the reporting entity.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 830-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-2 Disclosure of a rate change that occurs after the date of the reporting entity's financial statements and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary. If disclosed, the disclosure shall include consideration of changes in unsettled transactions from the date of the financial statements to the date the rate changed. In some cases it may not be practicable to determine these changes; if so, that fact shall be stated.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 830-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-2 Disclosure of a rate change that occurs after the date of the reporting entity's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the reporting entity and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary.</td>
</tr>
</tbody>
</table>

Under ASC 830-30-45-16, an entity should not adjust its financial statements to reflect changes in exchange rates that occur after the balance sheet date of a reporting entity or foreign entity included in the financial statements. Rather, in accordance with ASC 830-20-50-2 and ASC 830-30-50-2, an entity must disclose significant effects of changes in exchange rates related to unsettled foreign currency transactions.

3.3.1 Significant Devaluation for Subsidiaries Reporting on a Lag

<table>
<thead>
<tr>
<th>ASC 830-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-8 If a foreign entity whose balance sheet date differs from that of the reporting entity is consolidated or combined with or accounted for by the equity method in the financial statements of the reporting entity, the current rate is the rate in effect at the foreign entity’s balance sheet date for purposes of applying the requirements of this Subtopic to that foreign entity.</td>
</tr>
</tbody>
</table>
Despite the guidance in ASC 830-30-45-8 above, it may sometimes be appropriate to translate the financial statements of a consolidated subsidiary by using an exchange rate as of the parent's balance sheet date.

ASC 810-10-45-12 and SEC Regulation S-X, Rule 3A-02, state that “recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations” (emphasis added) that occur during the reporting time lag (i.e., the period between the subsidiary's year-end reporting date and the parent's balance sheet date). We believe that an entity may elect a policy of either disclosing, or disclosing and recognizing, all material intervening events, including changes in exchange rates, provided that either policy is consistently applied.

**Example 3-2 — Significant Devaluation for Subsidiaries Reporting on a Lag**

A parent company includes a foreign subsidiary's financial statements for the year ended November 30, 20X1, in the parent company's consolidated financial statements for the year ended December 31, 20X1. Between November 30 and December 31, the functional currency of the subsidiary devalues significantly against the parent company's reporting currency.

Therefore, the parent company should consider whether the devaluation of the foreign subsidiary's functional currency constitutes a material intervening event. If the parent company concludes that the devaluation is a material intervening event and has an established accounting policy to disclose and recognize material intervening events, it should use the December 31, 20X1, exchange rate to translate the subsidiary's November 30, 20X1, financial statements. In all circumstances, regardless of which policy is elected, detailed disclosure should be provided in the financial statements.
Chapter 4 — Foreign Currency Transactions

4.1 Chapter Overview

ASC 830-20 addresses the accounting for foreign currency transactions, which the ASC master glossary defines as transactions “whose terms are denominated in a currency other than the entity’s functional currency.” However, the guidance in ASC 830-20 is limited to the measurement and presentation of foreign currency transactions. Therefore, it does not provide guidance on when an entity should recognize a foreign currency transaction in its financial statements. Entities should apply other relevant accounting guidance to determine when a foreign currency transaction should be recognized.

Broadly speaking, there are two types of foreign currency transactions: (1) those that result in the receipt or payment of foreign currency cash only on the date on which the transaction is recognized (e.g., purchasing or selling inventory by using foreign currency cash) and (2) those that will result in the receipt or payment of foreign currency cash on a future date (e.g., purchasing or selling inventory on account). For the first type of foreign currency transaction, the only relevant accounting issue is how to initially measure the recognized asset, liability, or income statement account in the entity’s financial statements. However, for the second type of foreign currency transaction, an additional issue arises with respect to the subsequent measurement of the recognized asset or liability in the financial statements.

The remainder of this chapter focuses on the initial and subsequent accounting for foreign currency transactions.

4.2 Initial Measurement of Foreign Currency Transactions

<table>
<thead>
<tr>
<th>ASC 830-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-1 At the date a foreign currency transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be recorded in the functional currency of the recording entity.</td>
</tr>
<tr>
<td>30-1 At the date a foreign currency transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured initially in the functional currency of the recording entity by use of the exchange rate in effect at that date.</td>
</tr>
</tbody>
</table>

Under ASC 830-20-25-1 and ASC 830-20-30-1, all foreign currency transactions must be measured in the recording entity’s functional currency. This is accomplished by using the exchange rate in effect on the date on which the transaction is recognized. However, as discussed in Chapter 3, an entity may, out of convenience, determine that an appropriately weighted-average exchange rate may be used for measuring income statement accounts. Example 4-1 illustrates the initial measurement of a foreign currency transaction.
Example 4-1 — Initial Measurement of a Foreign Currency Transaction

On September 15, 20X6, Retailer, a U.S. entity whose functional currency is the USD, purchases inventory from Supplier, a Japanese entity whose functional currency is the JPY (¥). The amount that Retailer owes Supplier for the inventory is ¥1,300. Assume that the exchange rate in effect on September 15, 20X6, is $1 = ¥6.50.

This transaction represents a foreign currency transaction for Retailer since its functional currency is the USD and the transaction price is denominated in a different currency (the JPY). In accordance with ASC 830-20, Retailer must record the transaction in its functional currency (USD). To determine the amount to record in USD, Retailer divides the transaction price (¥1,300) by the exchange rate that was in effect when the transaction was recognized ($1 = ¥6.50). Therefore, Retailer would record the following journal entry in its financial statements on September 15, 20X6:

\[
\begin{align*}
\text{Inventory} & \quad 200 \\
\text{Accounts payable} & \quad 200
\end{align*}
\]

From Supplier's perspective, this transaction does not represent a foreign currency transaction since it is denominated in its functional currency (JPY). Therefore, Supplier recognizes the transaction in its financial statements at the stated transaction price (¥1,300).

4.3 Subsequent Measurement of Foreign Currency Transactions

ASC 830-20

35-1 A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes.

35-2 At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date. Paragraphs 830-20-30-2 through 30-3 provide more information about exchange rates.

ASC 830-20-35-2 specifies that if a recorded balance is denominated in a foreign currency, it must be remeasured in each period into the functional currency by using the current exchange rate. (See Chapter 3 for a discussion of current exchange rates.) ASC 830-20-35-1 further clarifies that the changes in those recorded balances, which result from fluctuations in the current exchange rate, are generally recorded in earnings. The overall objective of this remeasurement process is explained in ASC 830-10-45-17:

If an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. If a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be in accordance with the requirements of Subtopic 830-20. **The remeasurement process is intended to produce the same result as if the entity's books of record had been maintained in the functional currency. To accomplish that result, it is necessary to use historical exchange rates between the functional currency and another currency in the remeasurement process for certain accounts (the current rate will be used for all others), and this guidance identifies those accounts. To accomplish that result, it is also necessary to recognize currently in income all exchange gains and losses from remeasurement of monetary assets and liabilities that are not denominated in the functional currency (for example, assets and liabilities that are not denominated in dollars if the dollar is the functional currency).**
ASC 830-10-45-17 states that to comply with the requirements in ASC 830-20 regarding the subsequent accounting for foreign currency transactions, an entity must use historical exchange rates to remeasure some accounts and current exchange rates to remeasure others. This guidance further suggests that “monetary” assets and liabilities would be subject to remeasurement at current exchange rates. In addition, ASC 830-10-45-18 identifies certain “nonmonetary” accounts that must be remeasured by using historical exchange rates. Therefore, the subsequent measurement of a foreign currency transaction depends on whether it results in the recognition of monetary or nonmonetary assets and liabilities, as illustrated below.

![Diagram](image)

Therefore, properly identifying an account as either monetary or nonmonetary is critical to correctly applying the subsequent-measurement guidance in ASC 830-20. The next section explains how to distinguish between the two.

### 4.3.1 Distinguishing Monetary Assets and Liabilities From Nonmonetary Assets and Liabilities

While the guidance in ASC 830-10-45-17 and 45-18 suggests that the subsequent-measurement requirements for monetary assets and liabilities (at current exchange rates) differ from those for nonmonetary assets and liabilities (at historical exchange rates), it does not actually define either of those terms. Therefore, we believe that it is important for entities to consider the guidance in ASC 830-20-35-1 when distinguishing between the two. This paragraph states that recorded balances that are denominated in a foreign currency must be remeasured at current exchange rates (i.e., those accounts would be considered monetary assets and liabilities). The implementation guidance in ASC 830-10-55-1 and 55-2 clarifies the meaning of a recorded balance that is “denominated in a foreign currency.”
Measurement in a Foreign Currency

55-1 To measure in foreign currency is to quantify an attribute of an item in a unit of currency other than the reporting currency. Assets and liabilities are denominated in a foreign currency if their amounts are fixed in terms of that foreign currency regardless of exchange rate changes. An asset or liability may be both measured and denominated in one currency, or it may be measured in one currency and denominated in another.

55-2 For example, two foreign branches of a U.S. entity, one Swiss and one German, purchase identical assets on credit from a Swiss vendor at identical prices stated in Swiss francs. The German branch measures the cost (an attribute) of that asset in EUR. Although the corresponding liability is also measured in EUR, it remains denominated in Swiss francs since the liability must be settled in a specified number of Swiss francs. The Swiss branch measures the asset and liability in Swiss francs. Its liability is both measured and denominated in Swiss francs. Although assets and liabilities can be measured in various currencies, rights to receive or obligations to pay fixed amounts of a currency are, by definition, denominated in that currency.

As noted above, a recorded balance is denominated in a foreign currency (and is therefore subject to remeasurement at current exchange rates) if its amount is “fixed in terms of that foreign currency regardless of exchange rate changes.” Further, “rights to receive or obligations to pay fixed amounts of a currency are, by definition, denominated in that currency.” Accordingly, this implementation guidance suggests that an account would be remeasured at current exchange rates (and therefore would be a monetary asset or liability) if it represents a right to receive or an obligation to pay a fixed amount of a foreign currency regardless of exchange rate changes. All other accounts thus would be considered nonmonetary and would be remeasured at historical exchange rates.

In addition, while ASC 830 does not explicitly define the terms “monetary assets and liabilities” or “nonmonetary assets and liabilities,” other Codification topics do, notably ASC 255 (on changing prices) and ASC 845 (on nonmonetary exchanges). While neither of these standards amended or interpreted the guidance in ASC 830, we believe that entities may find it useful to consider the below definitions in applying this guidance.

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

Monetary Liability
An obligation to pay a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods and services.
ASC 845-10-20 — Glossary

Monetary Assets and Liabilities

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

Nonmonetary Assets and Liabilities

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

The table below summarizes common monetary and nonmonetary balance sheet accounts.

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Monetary</th>
<th>Nonmonetary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in equity securities (including those accounted for under the equity method)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in debt securities classified as trading or available for sale (AFS)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in debt securities classified as held to maturity (HTM)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables and related allowances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refundable deposits and advances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PP&amp;E (including accumulated depreciation)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill and intangible assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred charges and credits (except policy acquisition costs for life insurance companies)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unamortized policy acquisition costs for life insurance companies</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Monetary</th>
<th>Nonmonetary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts, notes, and dividends payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refund liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred revenue/income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds payable and other long-term debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax liabilities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Sections 4.3.2 and 4.3.3 discuss how to subsequently measure foreign currency transactions that result in the recognition of monetary assets and liabilities and those that result in the recognition of nonmonetary assets and liabilities.

4.3.2 Monetary Assets and Liabilities

When a foreign currency transaction results in the recognition of a monetary asset or liability, that asset or liability is subsequently remeasured from the foreign currency to the functional currency as of each reporting date by using the current exchange rate. Therefore, the carrying value of a monetary asset or liability will change on each reporting date (until the asset or liability is settled) as a result of changes to the exchange rate between the foreign currency and the functional currency. Generally, these changes in the carrying value of monetary assets and liabilities are recognized in earnings as transaction gains or losses. However, there are certain exceptions to recognizing such transaction gains and losses in earnings, which are discussed in further detail in Section 9.2.

Connecting the Dots

Transaction gains or losses are generally recorded in earnings because the change in the exchange rate directly affects the amount of functional currency that the entity will either receive or pay when the transaction is settled. That is, changes in exchange rates have direct effects on the entity's future cash flows.

Example 4-2 illustrates the subsequent measurement of a foreign currency transaction that results in the recognition of a monetary liability:

Example 4-2 — Subsequent Measurement of a Monetary Liability

This example represents a continuation of Example 4-1. Assume the following additional facts:

- The terms of the transaction specify that Retailer must pay for the inventory in 60 days (on November 14, 20X6).
- Retailer is a calendar-year public company that files quarterly financial statements.
- The exchange rates in effect on Retailer’s quarterly reporting date and at the time the transaction is settled, respectively, are as follows:
  - September 30, 20X6: $1 = ¥6.25.
  - November 14, 20X6: $1 = ¥6.75.

See Section 4.6.1 for further discussion of instruments that must be subsequently remeasured under ASC 480-10-S99.
Chapter 4 — Foreign Currency Transactions

Example 4-2 — Subsequent Measurement of a Monetary Liability (continued)

The original transaction between Retailer and Supplier resulted in Retailer's recognition of an accounts payable balance, which is a monetary liability. Therefore, Retailer must remeasure that account as of each reporting date by using the exchange rate in effect on that date. Accordingly, on September 30, 20X6, Retailer remeasures its accounts payable balance by dividing the transaction price of ¥1,300 by the exchange rate in effect on that date ($1 = ¥6.25) and determines it to be $208. To adjust the carrying value of the accounts payable balance, Retailer would record the following journal entry in its financial statements on September 30, 20X6:

Foreign currency transaction loss 8
Accounts payable 8

Because the JPY has strengthened against the USD since the time the transaction was executed, Retailer now needs more USD (its functional currency) to pay for the inventory. Retailer therefore records a foreign currency transaction loss in earnings to reflect the additional amount of functional currency needed to settle its liability.

On November 14, 20X6, Retailer settles the transaction by paying Supplier ¥1,300. To record the settlement in its financial statements, Retailer must first remeasure its accounts payable by using the exchange rate in effect on the settlement date. Accordingly, Retailer remeasures its accounts payable balance by dividing the transaction price of ¥1,300 by the exchange rate in effect on that date ($1 = ¥6.75), and determines it to be $193 (rounded). To adjust the carrying value of the accounts payable balance and settle the accounts payable balance, Retailer would record the following journal entries in its financial statements on November 14, 20X6:

Accounts payable 193
Foreign currency transaction gain 15
Cash 193

From September 30, 20X6, through the settlement date, the JPY has weakened against the USD. Therefore, Retailer now needs fewer USD to settle its obligation than it did on September 30, 20X6, because of the change in the exchange rate. The remeasurement therefore results in the recognition of a transaction gain.

4.3.3 Nonmonetary Accounts

When a foreign currency transaction results in the recognition of a nonmonetary asset or liability, that asset or liability is subsequently remeasured by using the historical exchange rate. By using the historical exchange rate, an entity will achieve the same results as it would if it had originally acquired the asset or incurred the liability in its functional currency, which is consistent with the remeasurement objective of ASC 830-10-45-17. Therefore, the carrying value of nonmonetary assets and liabilities will not change as a result of changes in exchange rates between the foreign currency and the functional currency. As a result, transaction gains or losses are not recognized for nonmonetary assets and liabilities.

Note that the foreign currency transaction illustrated in Examples 4-1 and 4-2 resulted in the recognition of both a nonmonetary asset (inventory) and a monetary liability (accounts payable). However, unlike the subsequent accounting for accounts payable in Example 4-2, the inventory would continue to be remeasured as of each reporting date at the historical exchange rate. Therefore, Retailer would continue to measure the inventory at $200 in its financial statements until it is sold or otherwise disposed of (i.e., changes in the exchange rate would not affect the carrying value of the inventory).
Chapter 4 — Foreign Currency Transactions

Connecting the Dots
While ASC 830 requires that nonmonetary assets and liabilities be subsequently remeasured at historical exchange rates, other authoritative literature may require that those assets and liabilities be subsequently remeasured at current exchange rates. For example, foreign-currency-denominated investments in AFS debt and equity securities are identified by ASC 830 as nonmonetary assets and therefore would need to be remeasured by using historical exchange rates. However, ASC 320 (as discussed further in Section 4.4.1) requires that AFS debt and equity securities be subsequently remeasured at fair value, a component of which is related to foreign currency exchange rates.

We believe that other authoritative literature takes precedence over ASC 830 in such cases and that the asset or liability should be subsequently remeasured in accordance with such literature. Therefore, if a foreign-currency-denominated asset or liability is deemed nonmonetary, an entity should further consider whether other authoritative literature requires that the asset or liability be subsequently measured at current exchange rates. Changes in the carrying value of the asset or liability that are related to changes in exchange rates would not necessarily be reported as transaction gains and losses under ASC 830 but should be presented in accordance with the requirements of those other standards.

4.3.4 Remeasurement of Books and Records Maintained in a Foreign Currency

<table>
<thead>
<tr>
<th>ASC 830-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-2 Paragraphs 830-10-55-3 through 55-7 provide guidance on the determination of a reporting entity’s functional currency. Paragraph 830-10-45-17 states that, if an entity’s books of record are not maintained in its functional currency, remeasurement into the functional currency is required before translation into the reporting currency. That paragraph provides further guidance on remeasurement of books and records.</td>
</tr>
</tbody>
</table>

ASC 830-20-25-2 states that if an entity maintains its books and records in a currency other than its functional currency, “remeasurement into the functional currency is required before translation into the reporting currency.” Such situations occur most commonly when an entity maintains its books and records in the local currency but, because it operates in a highly inflationary economy, uses the reporting currency of its immediate parent as its functional currency. (See Chapter 7 for a further discussion of highly inflationary economies.) However, this requirement applies to all situations in which an entity maintains its books and records in a currency that differs from its functional currency.

In such situations, nonmonetary assets and liabilities must be remeasured at historical exchange rates (i.e., the exchange rates in effect when the assets or liabilities were initially recognized) while monetary assets and liabilities must be remeasured at current exchange rates. Accordingly, remeasurement of monetary assets and liabilities from the foreign currency into the functional currency will result in the recognition of transaction gains or losses in earnings. The objective of such remeasurement is to produce the same results as those that would be produced if the entity had maintained its books and records in the functional currency; this objective is consistent with the overall remeasurement principle in ASC 830-10-45-17.

4.4 Investments in Debt and Equity Securities Under ASC 320-10

In accordance with ASC 320-10, investments in debt and equity securities can be classified as trading; AFS; or, in the case of debt securities, HTM. Such classification dictates the foreign currency accounting for these investments.
4.4.1 Investments in Trading and AFS Securities

**AS 320-10**

35-1 Investments in debt securities and equity securities shall be measured subsequently as follows:

a. Trading securities. Investments in debt securities that are classified as trading and equity securities that have readily determinable fair values that are classified as trading shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for trading securities shall be included in earnings.

b. Available-for-sale securities. Investments in debt securities that are classified as available for sale and equity securities that have readily determinable fair values that are classified as available for sale shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraphs 815-25-35-1 through 35-4. . . .

**Pending Content (Transition Guidance: AS 825-10-65-2)**

35-1 Investments in debt securities shall be measured subsequently as follows:

a. Trading securities. Investments in debt securities that are classified as trading shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for trading securities shall be included in earnings.

b. Available-for-sale securities. Investments in debt securities that are classified as available for sale shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraphs 815-25-35-1 through 35-4. . . .

Investments in debt and equity securities that are classified as either trading or AFS under AS 320-10 are nonmonetary assets and therefore are not subject to remeasurement at current exchange rates under AS 830. However, AS 320-10-35-1 requires that trading and AFS securities be subsequently remeasured at fair value.

If a trading or AFS security is denominated in a foreign currency, changes in the exchange rate between the foreign currency and an entity's functional currency will affect the security's fair value. Therefore, under AS 320-10, the trading or AFS security must be remeasured from the foreign currency to the functional currency as of each reporting date by using the current exchange rate to determine the fair value of the security.

ASC 320 further requires that all changes in the fair value of a trading security be recognized in earnings. Conversely, all changes in the fair value of an AFS security must be recognized in OCI.
Connecting the Dots

It would not be appropriate for an entity to bifurcate the change in the fair value of a trading or AFS security related strictly to the change in exchange rates and classify that portion as a transaction gain or loss in the income statement. Rather, the entire change in the security’s fair value (including the portion related to a change in the exchange rates) would be classified in accordance with ASC 320-10.

Example 4-3 — Foreign-Currency-Denominated Trading Security

Investor Co, a U.S. entity whose functional currency is the USD, purchases 750,000 shares of Lumber Co, a Canadian entity, on November 22, 20X6, for 1,000,000 CAD. Investor Co is a public entity with a calendar year-end. Assume the following facts:

- Investor Co classifies its investment in the shares in Lumber Co as a trading security under ASC 320-10.
- Investor Co sells its investment in the shares of Lumber Co on January 8, 20X7.
- Investor Co does not present realized gains and losses separately from unrealized gains and losses in its income statement.
- The fair value of Investor Co’s investment in the shares of Lumber Co and the exchange rates in effect at the time of purchase, sale, and year-end are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value (CAD)</th>
<th>Exchange Rate</th>
<th>Fair Value ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 22, 20X6</td>
<td>1,000,000</td>
<td>CAD 1 = $0.75</td>
<td>750,000</td>
</tr>
<tr>
<td>December 31, 20X6</td>
<td>1,100,000</td>
<td>CAD 1 = $0.80</td>
<td>880,000</td>
</tr>
<tr>
<td>January 8, 20X7</td>
<td>1,500,000</td>
<td>CAD 1 = $0.67</td>
<td>1,005,000</td>
</tr>
</tbody>
</table>

To account for its initial purchase of the shares of Lumber Co and the subsequent measurement of that investment, Investor Co would record the following journal entries:

**November 22, 20X6: To record the initial investment in Lumber Co:**

Investment in equity trading securities 750,000
Cash 750,000

**December 31, 20X6: To record the subsequent change in the fair value of its investment in Lumber Co:**

Investment in equity trading securities 130,000
Income statement 130,000

**January 8, 20X7: To record the sale of its investment in Lumber Co:**

Investment in equity trading securities 125,000
Income statement 125,000
Cash 1,005,000
Investment in equity trading securities 1,005,000

Note that if the securities in Example 4-3 were classified as AFS instead of as trading, Trading Co would record the unrealized gain on the investment through OCI rather than in earnings. Upon sale of its investment, the cumulative unrealized gain would be reclassified from OCI to earnings.
Changing Lanes

In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The ASU requires that all equity securities be measured at fair value through net income. However, for certain investments in equity securities without a readily determinable fair value that do not qualify for the net asset value practical expedient in ASC 820-10-35-59, an entity is permitted to elect a practicability exception to fair value measurement under which the investment will be measured at cost, less impairment, plus or minus observable price changes (in orderly transactions) for an identical or similar investment of the same issuer.

Therefore, once the ASU becomes effective, there will no longer be an AFS classification for equity securities (with changes in fair value reported through OCI). Accordingly, all changes in the fair value of an equity security, including those related to changes in exchange rates, will be reported in net income in a manner similar to the current accounting treatment for trading securities.

4.4.2 Investments in HTM Debt Securities

**ASC 320-10**

<table>
<thead>
<tr>
<th>35-1</th>
<th>Investments in debt securities and equity securities shall be measured subsequently as follows: . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>c.</td>
<td>Held-to-maturity securities. Investments in debt securities classified as held to maturity shall be measured subsequently at amortized cost in the statement of financial position. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to Subtopic 830-20.</td>
</tr>
</tbody>
</table>

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

<table>
<thead>
<tr>
<th>35-1</th>
<th>Investments in debt securities shall be measured subsequently as follows: . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>c.</td>
<td>Held-to-maturity securities. Investments in debt securities classified as held to maturity shall be measured subsequently at amortized cost in the statement of financial position. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to Subtopic 830-20.</td>
</tr>
</tbody>
</table>

Unlike trading and AFS securities, investments in debt securities that are classified as HTM under ASC 320-10 are monetary assets and therefore will give rise to transaction gains or losses under ASC 830-20. HTM debt securities are monetary assets because the amount that the entity will receive upon settlement is fixed and determinable. Further, unlike trading and AFS securities, HTM debt securities must be carried at amortized cost, not fair value.

---

2 The practicability exception is not available to (1) reporting entities that are investment companies, (2) broker-dealers in securities, or (3) postretirement benefit plans.
Accordingly, HTM debt securities that are denominated in a foreign currency must be remeasured as of each reporting date by using the current exchange rate. Any changes in the carrying value of the security that are attributable to changes in exchange rates should be reported as a transaction gain or loss in earnings. The following table summarizes the exchange rates that should be used to remeasure the accounts that may be associated with an investment in an HTM debt security:

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in HTM security</td>
<td>Current spot rate</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>Current spot rate</td>
</tr>
<tr>
<td>Interest income</td>
<td>Weighted-average rate</td>
</tr>
<tr>
<td>Amortization of premium or discount</td>
<td>Weighted-average rate</td>
</tr>
</tbody>
</table>

**Example 4-4 — Foreign-Currency-Denominated HTM Security Issued at Par**

On January 1, 20X6, Investor Co, a U.S. registrant whose functional currency is the USD, purchases a 10-year bond bearing 6 percent annual interest with a par value of 1,000,000 EUR. The purchase price of the bond is equal to its par value (i.e., no premium or discount is associated with the bond).

Assume that Investor Co classifies its investment in the bond as an HTM security under ASC 320-10 and that the following exchange rates are in effect during 20X6:

- January 1, 20X6: €1 = $1.2.
- December 31, 20X6: €1 = $1.5.
- Weighted average during 20X6: €1 = $1.3.

To record its initial investment in the bond in its functional currency, Investor Co records the following journal entry on January 1, 20X6 [€1,000,000 × (€1:$1.2)]:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (€)</th>
<th>Exchange Rate</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in HTM security</td>
<td>1,000,000</td>
<td>1.2</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,200,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The table below summarizes the various amounts that would be recorded in Investor Co’s financial statements on December 31, 20X6.

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Amount (€)</th>
<th>Exchange Rate</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in HTM security</td>
<td>1,000,000</td>
<td>1.5</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Accrued interest receivable (1,000,000 × 6%)</td>
<td>60,000</td>
<td>1.5</td>
<td>90,000</td>
</tr>
<tr>
<td>Interest income (1,000,000 × 6%)</td>
<td>60,000</td>
<td>1.3</td>
<td>78,000</td>
</tr>
<tr>
<td>Transaction</td>
<td></td>
<td></td>
<td>312,000</td>
</tr>
</tbody>
</table>

The transaction gain calculated above consists of two components: (1) remeasurement of the investment in the bond ($300,000) and (2) remeasurement of accrued interest receivable ($12,000). Since the investment in the bond is a monetary asset, it must be remeasured by using the current spot rate in effect as of December 31, 20X6. This process results in a transaction gain of $300,000 [€1,000,000 × (1.5 – 1.2)]. Further, because the accrued interest receivable also represents a monetary asset, it must also be remeasured at the spot rate. However, since the accrued interest receivable was recorded throughout the year at the weighted-average exchange rate (as the interest income was recognized), the transaction gain of $12,000 is calculated as the difference between the spot rate on December 31, 20X6, and the weighted-average exchange rate during 20X6 [€60,000 × (1.5 – 1.3)].
Example 4-5 — Foreign-Currency-Denominated HTM Security Issued at a Discount

Assume the same facts as in Example 4-4, except that Investor Co only pays €900,000 to purchase the bond (i.e., the bond is issued at a discount).

The table below reflects a simplified bond amortization schedule for 20X6.

<table>
<thead>
<tr>
<th>Date</th>
<th>Accrued Interest Receivable</th>
<th>Interest Income</th>
<th>Amortization of Discount</th>
<th>Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X6</td>
<td>€900,000</td>
<td></td>
<td></td>
<td>€900,000</td>
</tr>
<tr>
<td>December 31, 20X6</td>
<td>€60,000</td>
<td>€67,050</td>
<td>€7,050</td>
<td>€907,050</td>
</tr>
</tbody>
</table>

To record its initial investment in the bond in its functional currency, Investor Co records the following journal entry on January 1, 20X6 [€900,000 × (€1:$1.2)]:

Investment in HTM security 1,080,000
Cash 1,080,000

To subsequently account for the bond, Investor Co records the following journal entries during 20X6:

1. To record interest income, accrued interest, and the amortization of the bond discount at the weighted-average exchange rate:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest receivable</td>
<td>78,000</td>
</tr>
<tr>
<td>Investment in HTM security</td>
<td>9,165</td>
</tr>
<tr>
<td>Interest income</td>
<td>87,165</td>
</tr>
</tbody>
</table>

2. To remeasure the interest receivable at the December 31, 20X6, spot rate:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest receivable</td>
<td>12,000</td>
</tr>
</tbody>
</table>

3. To remeasure the December 31, 20X6, carrying value of the bond at the December 31, 20X6, spot rate:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in HTM security</td>
<td>271,410</td>
</tr>
</tbody>
</table>

Using the spot rate on December 31, 20X6, Investor Co determines that the functional currency value of the bond is $1,360,575 [12/31/X6 carrying value of €907,050 (from the amortization table above) × (€1:$1.5)]. To calculate the foreign currency transaction gain of $271,410, Investor Co compares this amount with the recorded value of the bond [$271,410 = $1,360,575 – ($1,080,000 + $9,165)].
4.4.3 Impairment

As illustrated in the flowchart below, ASC 320-10 prescribes a two-step approach for determining whether an impairment loss must be recognized for an AFS or HTM security.

In step 1, an entity determines whether the fair value of a foreign-currency-denominated security is less than its cost by doing the following:

1. Remeasuring the fair value of the security from the foreign currency to the entity's functional currency at the current exchange rate.

2. For an equity or AFS debt security (nonmonetary assets), remeasuring the cost of the security from the foreign currency to the entity's functional currency at the historical exchange rate (i.e., the exchange rate in effect when the security was acquired). For an HTM debt security (monetary asset), the amortized cost\(^3\) of the security would be remeasured from the foreign currency to the entity's functional currency by using current exchange rates.

\(^3\) HTM debt securities are measured at amortized cost (as opposed to fair value), and the ASC master glossary clarifies that the effects of foreign exchange are included as adjustments to a security’s amortized cost basis.
Chapter 4 — Foreign Currency Transactions

In step 2, the determination of whether an impairment loss is other than temporary differs depending on whether the security is equity or debt. For equity securities, the determination of whether an impairment is other than temporary depends on a number of factors, including the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the issuer’s intent and ability to hold the security until recovery. For debt securities, an impairment loss is considered other than temporary if (1) the entity intends to sell the security, (2) it is more likely than not that the entity will be required to sell the security before recovery of its cost, or (3) the entity does not expect to recover the entire amortized cost basis of the security (even if it does not intend to sell or it is not more likely than not that it will be required to sell).

If the fair value of a security is less than its cost and the impairment is determined to be other than temporary, an impairment loss must be recognized. The recognition of this impairment loss for foreign-currency-denominated securities (as determined under ASC 320-10) differs depending on whether the security is debt or equity, as explained below.

4.4.3.1 Impairment of AFS Equity Securities

ASC 320-10

35-34 If it is determined in Step 2 that the impairment is other than temporary, then an impairment loss shall be recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment shall not include partial recoveries after the balance sheet date. The fair value of the investment would then become the new amortized cost basis of the investment and shall not be adjusted for subsequent recoveries in fair value.

Pending Content (Transition Guidance: ASC 825-10-65-2)

Editor’s Note: Paragraph 320-10-35-34 will be superseded upon transition, together with its heading:

Equity Securities—If the Impairment Is Other Than Temporary, Recognize an Impairment Loss Equal to the Difference between the Investment's Cost Basis and Its Fair Value

35-34 Paragraph superseded by Accounting Standards Update No. 2016-01

Example 4-6 — Impairment of a Foreign-Currency-Denominated AFS Equity Security

Investor Co, a U.S. entity whose functional currency is the USD, purchases 750,000 shares of Lumber Co, a Canadian entity, on November 22, 20X6, for 1,000,000 CAD. Investor Co is a public entity with a calendar year-end. Assume the following facts:

- Investor Co classifies its investment in the shares in Lumber Co as an AFS security under ASC 320-10.
- The fair value of Investor Co’s investment in the shares of Lumber Co and the exchange rates in effect at the time of purchase, sale, and year-end are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value (CAD)</th>
<th>Exchange Rate</th>
<th>Fair Value ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 22, 20X6</td>
<td>1,000,000</td>
<td>CAD 1 = $0.75</td>
<td>750,000</td>
</tr>
<tr>
<td>December 31, 20X6</td>
<td>900,000</td>
<td>CAD 1 = $0.60</td>
<td>540,000</td>
</tr>
</tbody>
</table>
Example 4-6 — Impairment of a Foreign-Currency-Denominated AFS Equity Security (continued)

Further, assume that Investor Co determines that of the $210,000 impairment loss, $150,000 resulted from changes in the exchange rate. Provided that Investor Co determines that the impairment loss is other than temporary under step 2 of the impairment model in ASC 320-10, it would record the following journal entry:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment loss</td>
<td>$210,000</td>
</tr>
<tr>
<td>Investment in AFS securities</td>
<td>$210,000</td>
</tr>
</tbody>
</table>

As shown above, the $150,000 impairment loss attributable to changes in the exchange rate would not be recorded separately as a foreign currency transaction loss.

Changing Lanes

As discussed in Section 4.4.1, once ASU 2016-01 becomes effective, equity securities will no longer be classified as AFS. However, an entity may elect the practicability exception to measure certain equity securities at cost, less impairment, plus or minus observable price changes (in orderly transactions) for an identical or similar investment of the same issuer.

Under the ASU, entities that elect the practicability exception would still need to assess the equity investment for impairment. However, in an effort to simplify the impairment model for equity securities, the FASB eliminated the requirement in U.S. GAAP to assess whether an impairment of such an investment is other than temporary (i.e., the impairment model under the ASU is a single-step approach instead of a two-step approach as currently required). Under the ASU, as of each reporting period, an entity will qualitatively consider whether the investment is impaired on the basis of certain indicators. If it determines that the equity security is impaired on the basis of the qualitative assessment, the entity will recognize an impairment loss equal to the amount by which the security’s carrying amount exceeds its fair value.

For equity securities denominated in a foreign currency, the fair value would be determined in the entity’s functional currency at the current exchange rate. Further, the entire difference between the fair value of an equity security and its carrying value would be recorded in earnings as an impairment loss. Therefore, in a manner consistent with Example 4-6 above, the portion of the impairment loss attributable to changes in the exchange rate would not be recorded separately as a foreign currency transaction loss under ASC 830.

4.4.3.2 Impairment of AFS and HTM Debt Securities

ASC 320-10

35-34A If an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.

Pending Content (Transition Guidance: ASC 326-10-65-1)

Editor’s Note: Paragraph 320-10-35-34A will be superseded upon transition, together with its headings.

Recognition of an Other-Than-Temporary Impairment

Debt Securities: Determination of the Amount of an Other-Than-Temporary Impairment Recognized in Earnings and Other Comprehensive Income

35-34A Paragraph superseded by Accounting Standards Update No. 2016-13
Chapter 4 — Foreign Currency Transactions

ASC 320-10 (continued)

35-34B If an entity intends to sell the security or more likely than not 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 shall be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses, the entity shall consider the factors in paragraph 320-10-35-33F.

Pending Content (Transition Guidance: ASC 326-10-65-1)

35-34B Paragraph superseded by Accounting Standards Update No. 2016-13

35-34C If an 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 shall be separated into both of the following:
  a. The amount representing the credit loss
  b. The amount related to all other factors.

Pending Content (Transition Guidance: ASC 326-10-65-1)

35-34C Paragraph superseded by Accounting Standards Update No. 2016-13

35-34D The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

Pending Content (Transition Guidance: ASC 326-10-65-1)

35-34D Paragraph superseded by Accounting Standards Update No. 2016-13
In accordance with the guidance above, how an entity recognizes an impairment loss for an AFS or HTM debt security will differ depending on why the entity concluded that the loss was other than temporary under step 2 of the impairment model in ASC 320-10. The following flowchart summarizes the framework prescribed by ASC 320-10-35-34A through 35-34D:

1. **Does the entity intend to sell the debt security?**
   - **(ASC 320-10-35-33A)**
   - Yes: **Impairment loss is other than temporary.**
   - No: Proceed to the next step.

2. **Is it more likely than not that the entity will be required to sell the debt security before recovery of its amortized cost?**
   - **(ASC 320-10-35-33B)**
   - Yes: **Impairment loss is other than temporary.**
   - No, and **Does the entity expect to recover the entire amortized cost of the security (even if it does not intend to sell)?**
     - Yes: **Impairment loss is not other than temporary.**
     - No, and **Does the entity intend to sell the debt security?**
       - Yes: **Impairment loss is other than temporary.**
       - No: **Impairment loss is not other than temporary.**

3. **Is any portion of the other-than-temporary impairment (OTTI) related to (1) credit losses or (2) changes in exchange rates that the entity does not expect to recover?**
   - Yes: **This portion of OTTI is recognized in net income.**
   - No: **The OTTI is recognized in OCI.**

4. **Does the entity expect to recover the entire amortized cost of the security (even if it does not intend to sell)?**
   - **(ASC 320-10-35-33C)**
   - Yes: All impairment is recognized in net income.
   - No: Proceed to the next step.

5. **The entire impairment loss is recognized in net income.**
   - **(ASC 320-10-35-34B)**

6. **The OTTI is recognized in OCI.**
   - **(ASC 320-10-35-34D)**
Example 4-7 — Impairment of a Foreign-Currency-Denominated AFS Debt Security

Investor Co, a U.S. registrant whose functional currency is the USD, holds an investment in an AFS debt security that is denominated in GBP (£). On December 31, 20X7, Investor Co's balance sheet date, the fair value of the debt security is £600,000 and its amortized cost is £750,000. Assume that the exchange rates in effect on December 31, 20X7, and the date on which Investor Co acquired the investment are £1 = $1.3 and £1 = $1.5, respectively.

After performing step 1 of the impairment model in ASC 320-10, Investor Co concludes that an impairment loss exists because the fair value of the security is less than its amortized cost. The table below summarizes the related computation.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (£)</th>
<th>Exchange Rate</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>600,000</td>
<td>£1 = $1.3</td>
<td>780,000</td>
</tr>
<tr>
<td>Cost basis</td>
<td>750,000</td>
<td>£1 = $1.5</td>
<td>1,125,000</td>
</tr>
<tr>
<td>Impairment loss</td>
<td>(345,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Assume that in applying step 2 of the impairment model, Investor Co reaches the following conclusions:

- It does not intend to sell the debt security.
- It is not more likely than not that it will be required to sell the debt security before recovery of the security’s amortized cost.
- It does not expect to recover the entire amortized cost of the security.

Therefore, Investor Co concludes that the impairment loss is an OTTI under ASC 320-10-35-33C. Further, assume that Investor Co concludes that the OTTI consists of (1) $120,000 related to changes in exchange rates that it does not expect to recover, (2) $200,000 related to credit losses, and (3) $25,000 related to all other factors. In such circumstances, Investor Co would record the following journal entry to recognize the impairment loss:

\[
\begin{align*}
\text{Impairment loss (net income)} & \quad 320,000 \\
\text{Impairment loss (OCI)} & \quad 25,000 \\
\text{Investment in AFS securities} & \quad 345,000
\end{align*}
\]

If Investor Co had concluded that it would be able to recover the amount of loss caused by the change in exchange rates ($120,000), it would have recorded the following journal entry:

\[
\begin{align*}
\text{Impairment loss (net income)} & \quad 200,000 \\
\text{Impairment loss (OCI)} & \quad 145,000 \\
\text{Investment in AFS securities} & \quad 345,000
\end{align*}
\]

4.5 Debt

Foreign-currency-denominated debt is a monetary liability and therefore should be remeasured, as of each reporting date, in the functional currency at the current exchange rate. Any change in the functional-currency-denominated value of the debt caused by changes in exchange rates should be recognized as a transaction gain or loss.
4.5.1 Debt Issuance Costs

In April 2015, the FASB issued ASU 2015-03, which requires entities to present debt issuance costs (other than costs related to line-of-credit or revolving-debt arrangements) in the balance sheet as a direct deduction from the related debt liability rather than as a deferred charge. ASU 2015-03 became effective for all entities for financial statements issued for fiscal years beginning on or after December 15, 2015.

Before adopting ASU 2015-03, an entity may have remeasured debt issuance costs in its functional currency by using historical exchange rates, because (1) it presented debt issuance costs in the balance sheet as deferred charges under ASC 835-30 and (2) ASC 830-10-45-18(i) requires that deferred charges be treated as a nonmonetary balance sheet item that is remeasured by using historical rates.

Upon adopting ASU 2015-03, however, the remeasurement of the carrying amount of the debt liability in the entity's functional currency reflects any deduction related to debt issuance costs. Under ASC 830-10-45-17, monetary liabilities (including the carrying amount of a monetary debt liability that has been adjusted for debt issuance costs) are remeasured in the entity's functional currency by using current exchange rates.

**Connecting the Dots**

Paragraph BC6 of ASU 2015-03 suggests that the new guidance in ASU 2015-03 is “limited to simplifying the presentation of debt issuance costs” and that the “recognition and measurement guidance for debt issuance costs is not affected.” Notwithstanding the Board's stated intention of not changing the recognition and measurement guidance related to debt issuance costs, an entity that presented debt issuance costs (other than issuance costs associated with line-of-credit or revolving debt arrangements) as deferred charges and treated such costs as a nonmonetary item under ASC 830-10 before adopting ASU 2015-03 would need to (1) retrospectively adjust, upon transition to ASU 2015-03, its accounting for debt issuance costs under ASC 830-10 in accordance with ASC 835-30-65-1(c) and (2) perform remeasurement as of each subsequent reporting period by using current exchange rates.

4.6 Equity Transactions

As discussed in Section 4.3.3, equity-classified securities are nonmonetary accounts that must be measured at historical exchange rates (i.e., the rates that were in effect when the securities were issued).

ASC 480 provides guidance on determining whether a financial instrument with both debt- and equity-like characteristics must be classified as a liability (or, in certain circumstances, as an asset). ASC 480 applies to freestanding financial instruments only and therefore does not apply to embedded features in a hybrid instrument, such as a put option embedded in a preferred share. However, just because an entity concludes that it is not required to classify an instrument as a liability under ASC 480 does not mean that the instrument is automatically classified as equity. Rather, an entity must perform further analysis under other Codification subtopics (e.g., ASC 815-40, ASC 505) to determine whether the instrument should be classified as a liability or as equity.
4.6.1 Distinguishing Liabilities From Equity

Under ASC 480, certain financial instruments that embody an obligation of the issuer should be accounted for as liabilities even if their legal form is that of equity or involves obligations to repurchase or issue the entity's equity shares. ASC 480 requires that the following three classes of financial instruments be accounted for as liabilities (or, in some circumstances, as assets):

1. **Mandatorily redeemable financial instruments** — The issuer of a financial instrument that is in the form of a share must classify the share as a liability if it embodies an unconditional obligation requiring the issuer to redeem the share by transferring assets, unless redemption would occur only upon the liquidation or termination of the reporting entity (e.g., mandatorily redeemable shares and mandatorily redeemable noncontrolling interests (NCIs) that do not contain any substantive conversion features).

2. **Obligations to repurchase the issuer’s equity shares by transferring assets** — A financial instrument other than an equity share is classified as a liability if it both (1) embodies an obligation to repurchase the issuer's equity shares (or is indexed to such an obligation) and (2) requires (or may require) the issuer to settle the obligation by transferring assets (e.g., physically settled or net-cash-settled forward purchase contracts or written put options on the entity's own equity shares).

3. **Certain obligations to issue a variable number of shares** — A financial instrument that embodies an unconditional obligation or a financial instrument other than an outstanding share that embodies a conditional obligation that the issuer must or may settle by issuing a variable number of its equity shares is classified as a liability if the obligation's monetary value is based solely or predominantly on one of the following; (1) a fixed monetary amount, (2) variations on something other than the fair value of the issuer’s equity shares, or (3) variations inversely related to changes in the fair value of the entity's equity shares (e.g., share-settled debt and net-share-settled forward purchase contracts or written put options on the entity's own equity shares). See ASC 480-10-25-14 for more information.
In addition, ASC 480-10-S99 contains SEC staff guidance on how to account for and present redeemable equity instruments (including classification within equity) that are not classified as liabilities under ASC 480-10-25 in an entity's financial statements. As summarized in the table below, the foreign currency effects of financial instruments with characteristics of both debt and equity depend on whether those instruments are classified as liabilities, temporary equity, or permanent equity under ASC 480.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Foreign Currency Effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>The instrument represents a monetary liability and therefore should be remeasured, as of each reporting date, in the functional currency at the current exchange rate. Any change in the functional-currency-denominated value of the debt caused by changes in exchange rates should be recognized as a transaction gain or loss.</td>
</tr>
<tr>
<td>Temporary equity</td>
<td>Like other equity instruments, instruments classified in temporary equity on the balance sheet are considered nonmonetary accounts under ASC 830. Changes in exchange rates therefore will not result in transaction gains or losses under ASC 830. However, to the extent that the instrument must be subsequently remeasured under ASC 480-10-S99, the measurement of the instrument’s redemption value must incorporate the effect of exchange rates. That is, the effect of exchange rates would be recorded through retained earnings (or, in the absence of retained earnings, APIC) and included as an adjustment to net income available to common shareholders in the calculation of earnings per share. Further, although ASC 480-10-S99 does not address foreign currency, consideration of the effects of changes in exchange rates when applying the “floor” would be most consistent with the intention of the concept in that guidance.</td>
</tr>
<tr>
<td>Permanent equity</td>
<td>The instrument represents a nonmonetary account that must be measured at the historical exchange rate. Changes in exchange rates therefore will not result in transaction gains or losses.</td>
</tr>
</tbody>
</table>

### 4.6.2 Dividends

The declaration of a dividend, if the dividend is not paid on the declaration date, results in the recognition of a monetary liability (i.e., a dividend payable). If the dividend is payable in a currency other than the entity’s functional currency, it must be remeasured, as of each reporting date, in the functional currency at the current exchange rate. Any change in the functional-currency-denominated value of the dividend payable caused by changes in exchange rates is recognized as a transaction gain or loss. The FASB 52 Implementation Group addressed this issue in December 1981 when it decided that “the transaction adjustment on a dividend payable or receivable account should be charged or credited to income.” This accounting is required regardless of whether the dividend is payable to the entity’s parent or other third-party shareholders.
Example 4-8 — Foreign-Currency-Denominated Dividend

Company A, whose functional currency is the ZAR, declares a $60 million dividend to its equity shareholders on November 12, 20X6. The spot exchange rate on the declaration date is $1 = ZAR 10. Assume the following additional facts:

- The dividend will be paid in ZAR at the spot rate in effect on December 27, 20X6.
- The closing spot exchange rate on December 27, 20X6, is $1 = ZAR 12.
- The dividend of ZAR 720 million ($60 million × 12) is paid on January 14, 20X7.

Because the payable is denominated in a foreign currency (USD), A is at risk for fluctuations in the foreign currency exchange rate between the declaration date and December 27, the date on which the exchange rate is fixed so that the dividend can be paid. Therefore, A should record a transaction loss related to the liability for the devaluation of the ZAR to the USD for the period from November 12 through December 27. Since the dividend will be paid in ZAR (i.e., A’s functional currency), foreign exchange risk is no longer associated with this payable after December 27.

4.7 Refundable Advance Payments

Refundable advance payments (both amounts received from customers and amounts paid to suppliers) are monetary liabilities and assets. Therefore, if the amounts are refundable in a foreign currency, the recognized asset or liability must be remeasured in the functional currency on each reporting date at the current exchange rate.

SEC Considerations

SAB Topic 13 (codified in ASC 605-10-S99-1) addresses the classification of refundable fees that an entity receives before goods or services are delivered. Specifically, SAB Topic 13.A.4(a) states that when the customer has a unilateral right to terminate a contract (and receive a refund as a result), “the amounts received from customers or subscribers . . . should be credited to a monetary liability account such as ‘customers’ refundable fees.’”

4.8 Costs in Excess of Billings and Billings in Excess of Costs

The application of the percentage-of-completion method to recognize revenue under ASC 605-35 can result in the recognition of a current asset or a current liability depending on the relationship between the cumulative amount of revenue that has been recognized under the contract and the cumulative amount that has been billed to the customer. Specifically, an asset is recorded when the cumulative amount of revenue recognized exceeds the amount billed to the customer. This asset is generally described in the financial statements as “costs in excess of billings” or “unbilled accounts receivable.” Conversely, a balance sheet credit is recorded when the cumulative amount of revenue recognized is less than the amount billed to the customer. This credit is generally described in the financial statements as “billings in excess of costs.” The asset recognized for unbilled accounts receivable is a monetary asset; however, the credit recognized for billings in excess of costs is a nonmonetary liability.
Changing Lanes
In May 2014, the FASB issued ASU 2014-09 (codified in ASC 606), which, when it becomes effective, will supersede much of the current revenue guidance in U.S. GAAP.

However, in a manner consistent with ASC 605-35, ASC 606 requires the recognition of a (1) contract asset if an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due or (2) contract liability if an entity receives consideration (or an entity had an unconditional right to consideration) before it transfers a good or service to the customer. This requirement is similar to the current requirement in ASC 605-35 related to recognizing costs in excess of billings and billings in excess of costs.

Like billings in excess of costs, contract liabilities4 are nonmonetary liabilities because they require an entity to perform a service in the future. Likewise, contract assets are monetary assets for the same reason that costs in excess of billings are monetary assets under current guidance. That is, contract assets will ultimately be settled for a fixed amount of cash.

A separate issue arises if a single contract with a customer contains a performance obligation that is in a contract asset position and another performance obligation that is in a contract liability position. ASC 606 requires that contract assets and contract liabilities be presented on a net basis in the balance sheet. Therefore, questions have arisen regarding whether the guidance in ASC 830 should be applied to the gross contract asset and liability balances separately or only to the net contract asset/liability for a single contract.

We generally believe that the guidance in ASC 830 should be applied on a gross basis. Therefore, if a single contract contains both a contract asset and a contract liability, an entity would remeasure the gross contract asset as of each reporting date at the current exchange rate. An entity would not remeasure the gross contract liability since it represents a nonmonetary liability. We believe that the requirement to present contract assets and liabilities on a net basis does not affect the recognition and measurement of the asset and liability (i.e., the requirement strictly applies to presentation matters) and, therefore, that the “unit of account” is the gross asset and liability. However, we acknowledge that there may be other views on determining the unit of account under ASC 830. Entities are encouraged to consult with their accounting advisers if they are considering applying the guidance in ASC 830 to the net contract asset/liability for a single contract.

4 ASU 2016-20 clarifies that contract liabilities under ASC 606 are different from refund liabilities. Unlike contract liabilities, refund liabilities are monetary liabilities and therefore must be remeasured by using current exchange rates.
4.9 Inventory

ASC 830-10

55-8 The rule of cost or market, whichever is lower (as described in Subtopic 330-10), requires special application when the books of record are not kept in the functional currency. Inventories carried at cost in the books of record in another currency should be first remeasured to cost in the functional currency using historical exchange rates. Then, historical cost in the functional currency is compared with market as stated in the functional currency. Application of the rule in functional currency may require write-downs to market in the functional currency statements even though no write-down has been made in the books of record maintained in another currency. Likewise, a write-down in the books of record may need to be reversed if market exceeds historical cost as stated in the functional currency. If inventory has been written down to market in the functional currency statements, that functional currency amount shall continue to be the carrying amount in the functional currency financial statements until the inventory is sold or a further write-down is necessary. An asset other than inventory may sometimes be written down from historical cost. Although that write-down is not under the rule of cost or market, whichever is lower, the approach described in this paragraph might be appropriate. That is, a write-down may be required in the functional currency statements even though not required in the books of record, and a write-down in the books of record may need to be reversed before remeasurement to prevent the remeasured amount from exceeding functional currency historical cost.

Pending Content (Transition Guidance: ASC 330-10-65-1)

55-8 The guidance on the subsequent measurement of inventory in Subtopic 330-10 requires special application when the books of record are not kept in the functional currency. Inventories carried at cost in the books of record in another currency should be first remeasured to cost in the functional currency using historical exchange rates. Then, historical cost in the functional currency should be evaluated for impairment under the subsequent measurement guidance using the functional currency. Application of the subsequent measurement guidance in functional currency may require a write-down in the functional currency statements even though no write-down has been made in the books of record maintained in another currency. Likewise, a write-down in the books of record may need to be reversed if the application of the subsequent measurement guidance in the functional currency does not require a write-down. If inventory has been written down in the functional currency statements, that functional currency amount shall continue to be the carrying amount in the functional currency financial statements until the inventory is sold or a further write-down is necessary. An asset other than inventory may sometimes be written down from historical cost. Although different measurement guidance may be used to determine that write-down, the approach described in this paragraph might be appropriate. That is, a write-down may be required in the functional currency statements even though not required in the books of record, and a write-down in the books of record may need to be reversed before remeasurement to prevent the remeasured amount from exceeding functional currency historical cost.

ASC 830-10-45-18 states that inventory carried at cost is a nonmonetary asset. Therefore, when an entity maintains its books and records in a foreign currency, inventory must be remeasured in the functional currency at the historical exchange rate (i.e., the rate that was in effect when the inventory was purchased). ASC 830-10-55-8 further requires that the lower-of-cost-or-market test prescribed in ASC 330 be performed in the entity’s functional currency.

Therefore, in certain instances, an entity may determine that it is required to write down its inventory in its functional currency even though it is not required to do so in the foreign currency. This situation typically arises when the foreign currency has weakened against the functional currency since the time the inventory was acquired. Example 4-9 illustrates this concept.

5 In July 2015, the FASB issued ASU 2015-11, which requires an entity to measure inventory “at the lower of cost and net realizable value.” Therefore, the ASU eliminates the need to determine replacement cost and evaluate whether it is above the ceiling (NRV) or below the floor (NRV less a normal profit margin).
Example 4-9 — Lower-of-Cost-or-Market Test When Books and Records Are Maintained in a Foreign Currency

Parent Co, a U.S. registrant whose functional and reporting currency is the USD, has a subsidiary, Sub Co, that operates in Mexico. Assume that Sub Co is a distinct and separable operation and that its functional currency is the reporting currency (USD). Sub Co maintains its books and records in MXN, the local currency.

Assume that the following facts exist on December 31, 20X6:

- Sub Co’s inventory balance is $50,000, which is equal to the local currency amount of MXN 500,000 translated at the historical exchange rate of MXN 1 = $0.10.
- Sub Co determines that the market value of the inventory on December 31, 20X6, under ASC 330-10-35 is $25,500, as depicted in the table below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (MXN)</th>
<th>Exchange Rate</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Replacement cost</td>
<td>450,000</td>
<td>MXN 1 = $0.05</td>
<td>22,500</td>
</tr>
<tr>
<td>Net realizable value less profit margin</td>
<td>510,000</td>
<td>MXN 1 = $0.05</td>
<td>25,500</td>
</tr>
<tr>
<td>Net realizable value</td>
<td>600,000</td>
<td>MXN 1 = $0.05</td>
<td>30,000</td>
</tr>
</tbody>
</table>

As a result, Sub Co recognizes a lower-of-cost-or-market adjustment of $24,500 on December 31, 20X6. The inventory will be carried in Sub Co’s financial statements at $25,500 until it is disposed of or subsequently written down as a result of a further decline in its market value.

In this example, Sub Co is required to recognize a lower-of-cost-or-market adjustment in its functional currency even though no write-down in the local currency is required. That is, the market value of the inventory in the local currency is MXN 510,000, which is greater than its carrying value of MXN 500,000. A lower-of-cost-or-market adjustment is required because of the devaluation of the MXN against the USD since the inventory was acquired.

4.10 Property, Plant, and Equipment

ASC 830-10-45-18 states that PP&E are nonmonetary assets. Therefore, when an entity maintains its books and records in a foreign currency, PP&E must be remeasured in the functional currency at the historical exchange rate (i.e., the rate that was in effect when the PP&E was purchased). Further, upon a trigger event, ASC 360-10 requires entities to perform a two-step test to determine whether PP&E is impaired:

- **Step 1** — Compare the carrying amount of the PP&E with the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group).
- **Step 2** — If the carrying value of the PP&E exceeds the undiscounted cash flows determined in step 1, compare the carrying value of the PP&E with its fair value. If the carrying value exceeds the fair value, an impairment loss is recognized for the difference.

As with the accounting for inventory discussed in Section 4.9, an entity must test PP&E for impairment in its functional currency. Therefore, when an entity maintains its books and records in a foreign currency, a devaluation of the foreign currency against the functional currency could cause an entity to fail step 1 of the impairment test. This is because PP&E constitutes nonmonetary assets that must be remeasured at the historical exchange rate, while the undiscounted cash flows are measured at the exchange rate that is in effect when the impairment test is performed. As with inventory, an impairment of PP&E in the functional currency may result even though the entity is not required to report an impairment in the books and records maintained in the foreign currency. Example 4-10 illustrates this concept.
Parent Co, a U.S. registrant whose functional and reporting currency is the USD, has a subsidiary, Sub Co, that operates in Mexico. Sub Co is a distinct and separable operation whose functional currency is the reporting currency (USD). Sub Co maintains its books and records in MXN, the local currency.

Assume that Sub Co purchased a piece of equipment for MXN 250,000 in 20X6, when the exchange rate was MXN 1 = $0.10, and that the equipment is a single asset group under ASC 360-10. In 20X9, because of a significant decline in the operations of Sub Co, the equipment is tested for impairment under ASC 360-10. Assume that the following facts exist on December 31, 20X9:

- The carrying value of the equipment is $17,500 (MXN 175,000 measured at the historical exchange rate).
- The sum of undiscounted cash flows expected to result from the use and eventual disposition of the equipment is MXN 200,000.
- The exchange rate is MXN 1 = $0.05.
- The fair value of the equipment is $5,000.

Sub Co determines that the carrying value of the equipment ($17,500) exceeds the sum of the undiscounted cash flows ($10,000) on a functional currency basis. Therefore, Sub Co recognizes an impairment loss of $12,500 on December 31, 20X9 ($5,000 fair value less $17,500 carrying value).

As in Example 4-9, Sub Co must recognize an impairment loss in its functional currency even though no impairment exists in the local currency. That is, the sum of the undiscounted cash flows in the local currency is MXN 200,000, which is greater than the equipment's carrying value of MXN 175,000.

4.11 Leases

ASC 840 requires that an entity, at the inception of a lease agreement, classify a lease as either an operating lease or a capital lease. Under ASC 840-10-25-1, one criterion that results in a capital lease classification is if the present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property at lease inception (i.e., the “90 percent test”). If the minimum lease payments are payable in a foreign currency, the entity performs the 90 percent test in its functional currency by using the exchange rate that is in effect at lease inception.

If a lessee determines that a lease is a capital lease, it must record both an asset and a liability under ASC 840. The capital lease asset, which represents an investment in owned property, is a nonmonetary asset, while the capital lease liability, which represents an obligation to make future lease payments (in a manner similar to debt), is a monetary liability. Foreign-currency-denominated capital lease assets are accounted for in the same manner as PP&E purchased in a foreign currency, which is discussed in Section 4.10. Foreign-currency-denominated capital lease liabilities are accounted for in the same manner as foreign-currency-denominated debt, which is discussed in Section 4.5.

However, if a lessee determines that a lease is an operating lease, no asset or liability is recorded on the balance sheet. Under ASC 840-20-25-1, “rent shall be charged to expense by lessees (reported as income by lessors) over the lease term as it becomes payable (receivable).” If rent is payable or receivable in a foreign currency, an entity should measure rent expense or rent income in its functional currency by using the weighted-average exchange rate that is in effect during the reporting period.
Changing Lanes

In February 2016, the FASB issued ASU 2016-02 (codified in ASC 842), which represents a significant change from the existing accounting guidance for lessees because it will require lessees to record operating leases on the balance sheet, with limited exceptions.

ASC 842 requires lessees to recognize a right-of-use (ROU) asset and a lease liability as of the lease commencement date, regardless of lease classification. The implementation guidance in ASC 842-20-55-10 clarifies that a ROU asset is a nonmonetary asset and a lease liability is a monetary liability. Therefore, when a lease is denominated in a foreign currency, the ROU asset must be remeasured in the functional currency by using the historical exchange rate and the lease liability must be remeasured by using the current exchange rate (in a manner consistent with the discussion above on capital leases under ASC 840).

4.12 Share-Based Payments

Under ASC 718, share-based payment awards are classified as either liabilities or equity. As summarized in the table below, the foreign currency effects of share-based payment awards that are denominated in a foreign currency depend on the classification of the award.

<table>
<thead>
<tr>
<th>Classification Under ASC 718</th>
<th>Measurement Under ASC 718</th>
<th>Foreign Currency Effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>Generally, remeasured as of each reporting date at fair value until the award is settled.</td>
<td>The fair value of the award should be determined in the functional currency by using the current exchange rate. Fluctuations in the fair-value-based measure of the liability award are recorded as increases or decreases in compensation cost, either immediately or over the remaining service period, depending on the vested status of the award. Compensation cost is recorded in the functional currency by using the weighted-average exchange rate for the reporting period. Upon exercise, proceeds are measured at the spot rate in effect at that time, with any difference recorded in equity.</td>
</tr>
<tr>
<td>Equity</td>
<td>Generally, measured on the grant date; not subsequently remeasured.</td>
<td>Compensation cost is recorded in the functional currency by using the weighted-average exchange rate for the reporting period. Upon exercise, proceeds are measured at the spot rate in effect at that time, with any difference recorded in equity.</td>
</tr>
</tbody>
</table>
4.13 Deferred Taxes
As shown in the table in Section 4.3.1, deferred tax assets and deferred tax liabilities are classified as monetary accounts. Typically, an entity files its income tax return in the local currency of the jurisdiction in which it operates. Further, an entity's tax basis in assets and liabilities is generally determined in the local currency; accordingly, deferred taxes are typically measured in the local currency. Therefore, if an entity's functional currency is different from its local currency, deferred taxes must be remeasured in each reporting period at the current exchange rate. See Chapter 8 for further considerations related to accounting for income taxes.

4.14 Warranty Obligations
When an entity sells a product to its customer, it may also provide the customer with a warranty on that product. The warranty might be described as a manufacturer's warranty, a standard warranty, or an extended warranty. Some warranties protect the customer from defects that exist when the product is sold, while others protect the customer from faults that arise after the product has been received. In substance, an entity's warranty obligation represents a promise to stand ready to replace or repair the product in accordance with the terms and conditions of the warranty.

ASC 460-10-25-5 states that warranty obligations incurred in connection with the sale of goods or services represent contingent liabilities and that an entity should therefore accrue losses from warranty obligations when it meets the criteria in ASC 450-20-25-2. The liability recognized for an entity's warranty obligation represents a nonmonetary liability under ASC 830 (since it will not be settled in cash) and therefore would not be subject to remeasurement in each period.

4.15 Sales With a Right of Return
In some contracts, an entity sells a good to a customer and grants the customer the right to return the good for a refund (e.g., if the customer is dissatisfied with the product). Provided that the criteria in ASC 605-15-25-1 for recognizing the transaction as revenue are not met, an entity records a liability equal to the sales price paid by the customer. This liability represents a refundable deposit received from the customer and therefore is a monetary liability under ASC 830. Therefore, if the sales price of the good is denominated in a foreign currency, the entity should remeasure the liability in its functional currency as of each reporting date, with changes recognized in earnings as transaction gains or losses.

4.16 Sales of Future Revenues

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales of Future Revenues or Various Other Measures of Income</td>
</tr>
<tr>
<td>25-1 An entity receives cash from an investor and agrees to pay to the investor for a defined period a specified percentage or amount of the revenue or of a measure of income (for example, gross margin, operating income, or pretax income) of a particular product line, business segment, trademark, patent, or contractual right. It is assumed that immediate income recognition is not appropriate due to the facts and circumstances. The payment to the investor and the future revenue or income on which the payment is based may be denominated in a foreign currency.</td>
</tr>
</tbody>
</table>
ASC 470-10 requires that the proceeds received from an investor be classified as either deferred income or debt depending on the facts and circumstances. Specifically, ASC 470-10-25-2 states that there is a rebuttable presumption that the proceeds should be classified as debt if any of the following factors are present:

- The entity has significant continuing involvement in the generation of the cash flows due the investor.
- Variations in the entity’s revenue or income underlying the transaction have only a trifling impact on the investor’s rate of return.
- The transaction does not purport to be a sale.
- The transaction is cancelable by either party through payment of a lump sum or other transfer of assets by the entity.
- The investor has any recourse to the entity relating to the payments due the investor.
- The investor’s rate of return is implicitly or explicitly limited by the terms of the transaction.
- The entity has significant continuing involvement in the generation of the cash flows due to the investor.

If an entity concludes that proceeds received from the sale of future revenues should be classified as debt, it should account for the foreign currency effects in the same manner as that described in Section 4.5. If an entity concludes that proceeds received from the sale of future revenues should be classified as deferred income, it should account for the foreign currency effects in the same manner as billings in excess of costs, which are discussed in Section 4.8.

### 4.17 Debt-for-Equity Swap

The implementation guidance in ASC 830-20-55-1 through 55-3 describes a transaction in which a U.S. entity purchases dollar-denominated debt due from a foreign government, or an entity that operates in that foreign country, for less than its face value. The U.S. entity then exchanges that debt with the foreign country’s government in a transaction denominated in the foreign currency and is required to invest that money in its subsidiary operating in that foreign country. The foreign government’s intent in this transaction is generally to induce the U.S. entity to invest in long-lived assets in the foreign country (through its subsidiary in that country). The graphic below illustrates this transaction.
Debt-for-equity swap programs may be in place in financially troubled countries, since the intent of the above transaction is to induce the U.S. entity to invest in the foreign country (by purchasing long-lived assets through its foreign subsidiary). In practice, debt-for-equity swaps are complicated transactions that can involve several brokers and are subject to both domestic and international currency regulations.

In general, the U.S. entity will receive more proceeds from the foreign government than it paid to acquire the debt. Under ASC 830-20-55-2, the cost basis of any long-lived assets acquired or constructed should be reduced by the amount by which the foreign currency proceeds (received from the government) translated at the official exchange rate exceed the purchase cost of the debt. Example 4-11 illustrates this concept.

**Example 4-11 — Debt-for-Equity Swap**

Parent Co, a U.S. registrant whose functional and reporting currency is the USD, has a subsidiary, Sub Co, that operates in Brazil. Parent Co purchases USD-denominated debt with a principal amount of $5 million from a Brazilian bank for $2 million (the debt’s price in the secondary market). Immediately after acquiring the debt, Parent Co sells the debt to the Brazilian government for 15 million BRL, the local currency. The official exchange rate in effect on the date Parent Co sold the debt to Brazil was BRL 1 = $0.3. Therefore, the USD value of the proceeds received from the Brazilian government is $4.5 million ($15 million × 0.3).

In this example, the excess of the amount received from the Brazilian government over the amount paid to acquire the debt is $2.5 million ($4.5 million proceeds – $2 million purchase price). Assume that in accordance with the terms of the sale to the government, Parent Co is required to contribute the proceeds to Sub Co and that Sub Co must use the proceeds to acquire long-lived assets in Brazil. Under ASC 830-20-55-2, the carrying value of the long-lived assets acquired must be reduced by the $2.5 million of excess proceeds received from the Brazilian government.

### 4.18 Capitalized Interest

ASC 835-20-20 defines interest cost as follows:

> Interest cost includes interest recognized on obligations having explicit interest rates, interest imputed on certain types of payables in accordance with Subtopic 835-30, and interest related to a capital lease determined in accordance with Subtopic 840-30. With respect to obligations having explicit interest rates, interest cost includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

Interest costs are the only costs that are eligible for capitalization under ASC 835-20. Further, AICPA TIS Section 2210.27 states that if a foreign-currency-denominated loan is obtained to construct a building, “the transaction gains and losses are not part of the cost of the building, but are a result of the change in the exchange rate and are included in income each period in which the exchange rate fluctuates.” That is, transaction gains or losses are precluded from capitalization under ASC 835-20.

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6 After the adoption of ASU 2016-02, interest cost will be defined as follows: “Interest cost includes interest recognized on obligations having explicit interest rates, interest imputed on certain types of payables in accordance with Subtopic 835-30, and interest related to a finance lease determined in accordance with Topic 842. With respect to obligations having explicit interest rates, interest cost includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.” See the transition guidance in ASC 842-10-65-1 for more information.
SEC Considerations

The SEC staff presented its views on this issue in a March 20, 1995, letter to the Accounting Principles Commission of the Mexican Institute of Public Accountants. The staff stated, in part:

The staff believes that the amount subject to capitalization on USD borrowings should be the stated rate on such borrowings. Therefore, both the foreign exchange loss and the monetary gain are excluded from the amount subject to capitalization. Under this policy, the amount subject to capitalization on USD borrowings would be the same if the Mexican entity were a reporting company or a subsidiary of a U.S. company.

4.19 Defined Benefit Pension Plans

In some cases, the benefits payable to plan participants under defined benefit pension or other postretirement plans may be denominated in a currency other than an entity’s functional currency. For example, a foreign entity whose functional currency is the reporting currency of its parent may sponsor a defined benefit plan with benefit payments payable in the local currency. In these instances, it is also common for the plan assets to be denominated in the foreign currency.

Under ASC 715-30, a reporting entity must remeasure the funded status of its defined benefit plans annually or upon the occurrence of certain significant events (e.g., a plan amendment or curtailment). ASC 715-30 requires that the plan assets be remeasured at fair value and that the benefit obligation be remeasured at its actuarial present value. Further, ASC 715-30 requires that all changes in the funded status of a plan that occur as a result of this remeasurement process be recognized in OCI. However, ASC 715-30 does not explicitly address how an entity should consider the effects of exchange rate changes in remeasuring the funded status of a plan that is denominated in a foreign currency.

Under ASC 830, an entity that maintains its books and records in a currency other than the functional currency must remeasure those books and records in its functional currency. However, ASC 830 does not state whether a defined benefit plan should be remeasured from the foreign currency to the functional currency by using the current exchange rate or the historical exchange rate.

We believe that the funded status of a defined benefit plan that is denominated in a foreign currency should be remeasured in the functional currency by using the current exchange rate. As stated above, the plan assets must be remeasured at fair value under ASC 715-30. In such circumstances, an entity is required to use current exchange rates to measure the fair value of foreign-currency-denominated plan assets in functional-currency units. In addition, while the benefit obligation is not measured at fair value, it is remeasured at the amount for which the obligation could currently be settled. Therefore, we believe that a current exchange rate must be used to remeasure the benefit obligation so that the amount for which it could currently be settled is properly reflected in an entity’s functional currency.

However, because neither ASC 715-30 nor ASC 830 explicitly addresses how to account for the effects of exchange rate changes related to defined benefit plans (i.e., whether the change should be recorded as a component of OCI or in earnings), we believe that there are two acceptable views on presenting the change in the funded status of a defined benefit plan due to exchange rate fluctuations.

View A — Recognize Currency Adjustments in OCI

Under View A, the funded status of a defined benefit plan would be considered a nonmonetary asset or liability under ASC 830. This view is based on an analogy to the implementation guidance in ASC 255. Specifically, the table in ASC 255-10-55-1 states that the specific assets in “[p]ension, sinking, and other funds under an entity’s control. . . should be classified as monetary or nonmonetary” and that, for “[a]ccrued pension obligations,” the “[f]ixed amounts payable to a fund are monetary” and “all other amounts are nonmonetary.”
Therefore, because the funded status of a plan does not represent a “fixed amount payable to a fund,” it should be considered a nonmonetary asset or liability under ASC 255. However, as discussed in Section 4.3.2, other authoritative literature (in this case, ASC 715-30) may require that a nonmonetary asset or liability be subsequently remeasured at current exchange rates. Therefore, under View A, because ASC 715-30 requires that the funded status of a pension plan be remeasured at current exchange rates, changes in the carrying value should also be presented in accordance with ASC 715-30. Under ASC 715-30-25-4, all changes resulting from the remeasurement of the funded status of a plan are reported in OCI (provided that the entity’s accounting policy is to amortize the resulting gains and losses into net income over future accounting periods and not to immediately recognize those gains and losses in net income).

View B — Recognize Currency Adjustments in Income

Under View B, the funded status of a defined benefit plan would be considered a monetary asset or liability under ASC 830 for the following reasons:

- The account will ultimately be settled in cash, through either recovery of the net pension asset or settlement of the net pension liability.

- While not authoritative for entities reporting under U.S. GAAP, paragraph 16 of IAS 21 explicitly states that “pensions and other employee benefits to be paid in cash” are monetary items. Proponents of View B believe that IAS 21 and U.S. GAAP do not substantively differ regarding how an entity determines monetary and nonmonetary accounts when applying the guidance on accounting for the effects of exchange rate changes.

In accordance with ASC 830-10-45-17, all transaction gains and losses related to remeasurement of monetary assets and liabilities that are not denominated in the functional currency must be recognized currently in earnings.

The accounting for currency adjustments related to remeasuring a foreign-currency-denominated defined benefit plan in either OCI or earnings is an accounting policy election that should be applied consistently.
Chapter 5 — Foreign Currency Translations

5.1 Chapter Overview

ASC 830-10

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

This chapter focuses on ASC 830-30, which “provides guidance for translating foreign currency statements that are incorporated in the financial statements of a reporting entity by consolidation, combination, or the equity method of accounting.” An entity applies the translation guidance in ASC 830-30 to translate the functional-currency-denominated financial results of foreign entities into a common reporting currency when combining the results of domestic and foreign entities.

The concept of measuring foreign currency transactions under ASC 830-20 is distinct from the concept of translating financial statements under ASC 830-30. This distinction is important since the applicability of the two concepts differs, as does the treatment of the resulting gains and losses. The following diagram summarizes the difference between the two concepts:

- **Measure foreign currency transactions (Chapter 4)**
  - Measure foreign currency transactions in the functional currency.
  - Generally, recognize transaction gain or loss through earnings.

- **Translate financial statements (Chapter 5)**
  - Translate functional currency financial results into the reporting currency.
  - Recognize the translation adjustment as an unrealized gain or loss within CTA.
5.2 Translation Process

ASC 830-30 defines foreign currency translation as the “process of expressing in the reporting currency of the reporting entity those amounts that are denominated or measured in a different currency.” The translation guidance outlined in this chapter applies to an entity’s functional-currency-based results.

Example 5-1 — Translating Financial Statements

Company B, a Polish company that has identified the local currency (PLN) as its functional currency, is a subsidiary of Parent Co, a U.S. parent that uses the USD for reporting purposes. Company B has debt on its books that is denominated in USD and EUR.

Before translating its financial statements, B is first required to recognize transaction gains or losses related to its foreign-currency-denominated debt. To do so, B measures (1) the USD-denominated debt by using the exchange rates existing as of the balance sheet date for the PLN and the USD and (2) the EUR-denominated debt by using the exchange rates existing as of the balance sheet date for the PLN and the EUR. The offset to each of these entries is recorded in earnings as a transaction gain or loss.

Next, Parent Co translates the functional-currency (local-currency) financial statements of B into USD. As discussed in Section 5.2.1, the current exchange rate as of the balance sheet date is used to translate assets and liabilities while an appropriate rate (e.g., weighted-average exchange rate for the period) is used to translate revenues, expenses, and other income statement items. The translation adjustments are recorded as a CTA, a separate component of OCI.

While not specifically addressed in ASC 810 or ASC 830, multitiered organizations typically apply the translation process in the same sequence as the consolidation process (on a step-by-step basis).

Example 5-2 — Multilevel Consolidation

A U.S. parent wholly owns a second-tier German subsidiary, which in turn wholly owns a third-tier British subsidiary. The local currency is the functional currency for all entities, and the reporting currency of the consolidated entity is the USD.

When preparing the financial statements for the consolidation of the subsidiaries with the U.S. parent, the entities would do the following:

1. The German subsidiary would translate the British subsidiary’s GBP-denominated financial statements (i.e., the functional-currency financial statements) into EUR-denominated financial statements. The GBP-to-EUR translation adjustment would be recorded in the CTA of the German subsidiary’s financial statements.
2. The U.S. parent would then translate the EUR-denominated, consolidated financial statements of the German subsidiary into USD. The EUR-to-USD translation adjustment would be recorded in the CTA of the U.S. parent’s financial statements.

5.2.1 Effecting a Translation

When applying the guidance in ASC 830-30 to translate functional currency statements into a single reporting currency, an entity needs to identify the appropriate exchange rate to use for this purpose.
In addition to applying the appropriate exchange rates, when translating foreign currency statements of foreign entities that are consolidated, combined, or accounted for under the equity method, an entity may need to consider whether it needs to make additional adjustments to the translated balances for items such as intra-entity eliminations as well as goodwill and purchase price adjustments (i.e., basis differences), as discussed below. Timing differences between the investee’s reporting periods and those of the reporting entity (i.e., reporting time lags) should also be taken into account in the determination of the exchange rate to be applied for translation, as discussed in Section 3.3.1.

The following diagram illustrates the key factors an entity should consider when translating foreign currency statements:

**5.2.1.1 Exchange Rate**

**ASC 830-30**

45-3 All elements of financial statements shall be translated by using a current exchange rate as follows:

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

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

Under ASC 830-30, all financial statement elements must be translated by using a current exchange rate, which ASC 830-30-45-4 defines as “the rate as of the end of the period covered by the financial statements or as of the dates of recognition in those statements in the case of revenues, expenses, gains, and losses.” As noted in Section 3.2.1, for practicality reasons, ASC 830 permits the use of weighted-average exchange rates or other methods that provide a reasonable approximation of the rates in effect on the date of recognition.

The following is a summary of the exchange rates used in the translation process, as outlined in Section 3.2.1:

<table>
<thead>
<tr>
<th>Current</th>
<th>Historical</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Common stock</td>
<td>Revenues</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Preferred stock</td>
<td>Expenses</td>
</tr>
<tr>
<td></td>
<td>APIC</td>
<td>Gains</td>
</tr>
<tr>
<td></td>
<td>Dividends</td>
<td>Losses</td>
</tr>
<tr>
<td></td>
<td>Beginning retained earnings</td>
<td>Change in retained earnings from net income</td>
</tr>
</tbody>
</table>
Further, as outlined in Section 3.2.1, while ASC 830 does not provide guidance on which rate should be used to translate a foreign entity’s equity accounts, we believe that it would be appropriate to translate equity accounts at historical rates, except changes to retained earnings for current-period net income.

5.2.1.1.1 Translation of Balances Reclassified From AOCI

The accounting literature is not explicit on the exchange rate that applies to the translation of amounts reclassified from AOCI to earnings. Accordingly, questions have been raised regarding whether the translation of such balances should be based on (1) the historical exchange rate or (2) the current average exchange rate. The following graphic summarizes the difference between the two approaches:

For pension and other postretirement-related balances originally recognized in OCI and reclassified from AOCI to net periodic benefit cost in subsequent periods, both of these approaches are considered acceptable in practice. The selection of either approach would be viewed as an accounting policy election.

Under the historical exchange rate approach, AOCI is viewed as akin to retained earnings. Accordingly, since amounts accumulated in retained earnings are not translated at a current rate under ASC 830 (i.e., retained earnings do not fluctuate as a result of subsequent changes in exchange rates), the amounts reclassified from AOCI to net periodic benefit cost should not be retranslated. Similarly, since the amounts in AOCI have been previously recognized in comprehensive income, the reclassification from AOCI to earnings should not be viewed as a new recognition event from a translation perspective. Therefore, the amounts initially recognized in OCI and translated at the rate in effect at that time would reflect the balance subject to reclassification from AOCI to net periodic benefit cost.

Under the current average exchange rate approach, the reclassification of amounts in AOCI is viewed as akin to newly recognized earnings. Accordingly, the rate in effect at the time of reclassification, which will often be an average rate for the period as the pension and other postretirement amounts are released over time, would be used to determine the amount that is reclassified from AOCI to net periodic benefit cost. This treatment would be consistent with the ASC 830 approach for the initial recognition of income statement items.

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1 The glossary in ASC 220-20 indicates that the term “comprehensive income” encompasses all components of net income as well as all components of OCI and that OCI refers to “revenues, expenses, gains, and losses that [under GAAP] are included in comprehensive income but excluded from net income.”
While the historical exchange rate approach may be viewed as the more supportable of the two approaches, the current average exchange rate approach is considered acceptable in practice as an alternative for pension and other postretirement-related balances. Initially, the objective of permitting the use of the current average exchange rate approach for applicable pension and other postretirement amounts was to allow for consistency with the approach used before the adoption of FASB Statement 158, since the amendments were not intended to change the measurement of the applicable pension and other postretirement balances. Before FASB Statement 158 (codified in ASC 715), unrecognized prior service costs/credits, net gains or losses, and translation obligations/assets remained off-balance-sheet and were translated at the average exchange rates for the period when these amounts were recognized in net periodic benefit cost.

For other balances deferred in AOCI (e.g., AFS investments, amounts related to certain hedging instruments), ASC 830 similarly does not address the exchange rate applicable to translation of amounts reclassified from AOCI to earnings. In such cases, while it may be more supportable under ASC 830 to use the historical exchange rate approach than it is to use the current average exchange rate approach, we believe that an entity may elect either approach as an accounting policy.

5.2.1.2 Intra-Entity Transactions

ASC 830-30-45-10 The elimination of intra-entity profits that are attributable to sales or other transfers between entities that are consolidated, combined, or accounted for by the equity method in the reporting entity’s financial statements shall be based on the exchange rates at the dates of the sales or transfers. The use of reasonable approximations or averages is permitted.

In a manner consistent with the accounting for consolidations, combinations, and the equity method of accounting, intra-entity profits are generally eliminated.

For transactions that are eliminated, ASC 830-30-45-10 prescribes the use of the sale or transfer date exchange rate, or approximation thereof, which is consistent with the exchange rate applicable to income statement items (as discussed in Section 5.2.1.1 above). This requirement results in the application of an exchange rate to items subject to elimination that is consistent with the rate applicable to items that are not eliminated.

However, intra-entity foreign-currency-denominated transactions may not be eliminated in all cases, as discussed in Chapter 6. Accordingly, such transactions would result in earnings volatility, in the absence of qualifying as a long-term investment, since the transaction would be remeasured to the functional currency through earnings while the translation to the reporting currency would be deferred through OCI.

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2 Upon adopting FASB Statement 158 (codified in ASC 715), companies and their subsidiaries (domestic and foreign) were required to recognize the funded status of their defined benefit plans. Accordingly, previously unrecognized amounts (including gains or losses, prior service costs or credits, and transition assets or obligations) were recorded, net of tax, as a component of AOCI. However, FASB Statement 158’s recognition provisions did not change how net periodic benefit cost is measured or recognized in an entity’s financial statements. However, after adoption of FASB Statement 158, ASC 715-30-35 and ASC 715-60-35 required that prior service costs or credits, and gains or losses, respectively, that arise during the period, and that are not immediately recognized as a component of net periodic benefit cost, be recognized as a component of OCI. Such amounts will ultimately be reclassified to net periodic benefit cost in subsequent periods. Accordingly, upon consolidation, parent companies with foreign subsidiaries that sponsor defined benefit plans will need to consider the impact of ASC 830 on the amounts recorded in, and reclassified from, AOCI.
Example 5-3 — Exchange Gain or Loss Related to Intra-Entity Loan

A U.S. parent, Company X, has a wholly owned subsidiary, Company Y, in the United Kingdom. Company X's functional currency is the USD, and Y's is the GBP. Company X has provided a loan in USD to Y. The loan is not regarded as part of X's net investment in Y.

No transaction gain or loss is recorded in the separate financial statements of the U.S. parent because the loan receivable is denominated in X's functional currency. In the subsidiary's separate financial statements, the loan payable is a monetary item and the transaction gain or loss related to remeasurement in Y's functional currency of the GBP is recognized in earnings in accordance with ASC 830-20.

Upon consolidation, although the intra-entity loan is eliminated from the statement of financial position, the related transaction gain or loss recognized in Y's separate financial statements for the USD loan payable survives the consolidation process; thus, the gain or loss is also recognized in consolidated earnings.

Further, in certain situations, the use of differing translation rates may result in residual intra-entity receivables and payables, as discussed in Section 6.2.1.

5.2.1.3 Goodwill and Purchase Price Adjustments

ASC 830-30-45-3 and ASC 830-30-45-11 require that an entity translate all elements of its financial statements, including goodwill and other basis differences. Therefore, in the determination of the currency translation adjustment in the acquirer’s consolidated financial statements, the individual assets (including goodwill) of an acquired foreign entity whose functional currency differs from its parent’s reporting currency must be translated on the basis of the amounts recognized by the acquirer under ASC 805-10, ASC 805-20, and ASC 805-30, even if that foreign entity elects not to apply pushdown accounting in its separate financial statements.

An entity can either record the amounts in the foreign entity's books (i.e., actual pushdown accounting) or maintain the records necessary to adjust the consolidated amounts to what they would have been had the amounts been recorded in the foreign entity's books and records (i.e., notional pushdown accounting).

Example 5-4 — Foreign Currency Translation for an Acquired Foreign Entity

Company A acquires Company B in a business combination. Company B is in a foreign jurisdiction, and B's functional currency of the USD differs from A's reporting currency, which is the EUR. Assume that the carrying value of all of B's assets and liabilities equals their fair values except for an intangible asset that was unrecognized in B's books but will be recognized in A's consolidated financial statements at its fair value of €1,000. Company A also recognizes goodwill of €150 from the acquisition of B in its consolidated financial statements. Company A has determined that B is a foreign entity. Company B has elected not to apply pushdown accounting in its separate financial statements. Therefore, B's assets are recognized at A's consolidated level by using A's basis in the assets, even though A's basis was not pushed down to B's separate financial statements.
Example 5-4 — Foreign Currency Translation for an Acquired Foreign Entity (continued)

As of the acquisition date, the intangible asset of €1,000 was the equivalent of $1,200 and the goodwill of €150 was the equivalent of $180 in B’s functional currency (exchange rate of $1.20 to €1). Although B did not elect pushdown accounting, when A translates B’s assets and liabilities from B’s functional currency to A’s reporting currency, A will translate B’s assets and liabilities into A’s reporting currency by using A’s basis in B’s assets and liabilities (i.e., stepped-up values) rather than the carrying values of B’s assets and liabilities in B’s separate financial statements. At the end of the reporting period, the carrying values of the intangible asset and goodwill in B’s functional currency are $1,080 ($1,200 less amortization of $120) and $180 and the exchange rate is $1.25 to €1. Therefore, in its consolidated financial statements, A recognizes B’s intangible asset of €864 ($1,080 ÷ 1.25) and goodwill of €144 ($180 ÷ 1.25). Because B did not elect pushdown accounting, separate accounting records will need to be maintained to adjust A’s consolidated amounts to what they would have been had the amounts been recorded in B’s separate financial statements (i.e., notional pushdown accounting).

The preceding is a simplified example in which a single foreign entity is acquired. In a multinational acquisition that includes multiple foreign and domestic entities, the application of ASC 830 may be complex depending on whether the acquirer needs to determine the amount of goodwill for each foreign and domestic entity acquired. We expect that an entity may need to use judgment in making such determinations.

5.2.2 Equity Method Investments

ASC 830-10

15-5 The functional currency approach applies equally to translation of financial statements of foreign investees whether accounted for by the equity method or consolidated. Therefore, the foreign currency statements and the foreign currency transactions of an investee that are accounted for by the equity method shall be translated in conformity with the requirements of this Topic in applying the equity method.

In a manner consistent with ASC 830-10-15-5 above, ASC 323 requires that an investee's income accounted for under the equity method be determined as if the investee were a consolidated subsidiary.

Accordingly, after the adjustments to the foreign investee's financial results, as outlined in ASC 323-10-35-5, the reporting entity should recognize and adjust its equity investment carrying amount for its share of the foreign investee's translated net income and OCI (including its share of the CTA).

The recognition date exchange rates, as discussed in Section 5.2.1, would be used to translate an investor's share of the net income of a foreign currency equity method investee into the investor's reporting currency (or a weighted-average exchange rate if appropriate). The historical rate would be applied to the existing investment balances.
Chapter 5 — Foreign Currency Translations

Example 5-5 — Translation of an Equity Method Investment

On January 1, 20X1, Company A, a U.S. entity whose functional currency is USD, acquires a 40 percent equity interest in Company B for 4 million euros. Company B is located in Germany, and its functional currency is the EUR.

Assume the following facts:

- Company A accounts for its investment in B as an equity method investment.
- Company A has determined that B is a foreign entity.
- Company B is in its first year of operations and generated net income of 1 million euros during 20X1.
- Company A did not recognize goodwill or other purchase price adjustments in relation to B, since B is a newly formed entity and the fair value of B was equal to the carrying amount at the time of acquisition by A.
- The following exchange rates were in effect during the period:
  - Spot rate on January 1, 20X1: €1 = $1.1.
  - Spot rate on December 31, 20X1: €1 = $1.3.
  - Weighted-average exchange rate during 20X1: €1 = $1.25.
- Company B’s statement of financial position on December 31, 20X1, denominated in euros and translated to U.S. dollars, is shown below.

<table>
<thead>
<tr>
<th>December 31, 20X1</th>
<th>€ (in thousands)</th>
<th>Exchange Rate*</th>
<th>$ (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,000</td>
<td>Current rate</td>
<td>1.30</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,500</td>
<td>Current rate</td>
<td>1.30</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>8,000</td>
<td>Current rate</td>
<td>1.30</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>3,000</td>
<td>Current rate</td>
<td>1.30</td>
</tr>
<tr>
<td>Total assets</td>
<td>14,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>1,000</td>
<td>Current rate</td>
<td>1.30</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>2,500</td>
<td>Current rate</td>
<td>1.30</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>3,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>1,000</td>
<td>Historical rate</td>
<td>1.10</td>
</tr>
<tr>
<td>APIC</td>
<td>9,000</td>
<td>Historical rate</td>
<td>1.10</td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening</td>
<td>—</td>
<td>Historical rate</td>
<td>—</td>
</tr>
<tr>
<td>20X1 earnings</td>
<td>1,000</td>
<td>Weighted-average rate</td>
<td>1.25</td>
</tr>
<tr>
<td>AOCI — CTA</td>
<td>—</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total equity</td>
<td>11,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>14,500</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* See Section 5.2.1 for an overview of the exchange rates that apply to each transaction and account type for translation purposes under ASC 830-30.

** The CTA is equal to B’s total assets (denominated in USD) less B’s total liabilities and shareholders’ equity (denominated in USD).
Chapter 5 — Foreign Currency Translations

Example 5-5 — Translation of an Equity Method Investment (continued)

Company A would record the following journal entries during 20X1, all denominated in USD:

**January 1, 20X1:**
To record its initial investment in B (€4 million × 1.1 exchange rate).

<table>
<thead>
<tr>
<th>Description</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in B</td>
<td>4,400,000</td>
</tr>
<tr>
<td>Cash</td>
<td>4,400,000</td>
</tr>
</tbody>
</table>

**December 31, 20X1:**
To record its share of B's net income (40% × [€1 million × 1.25 exchange rate]).

<table>
<thead>
<tr>
<th>Description</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in B</td>
<td>500,000</td>
</tr>
<tr>
<td>Income from equity method investee</td>
<td>500,000</td>
</tr>
</tbody>
</table>

To record its share of the CTA arising from translating B's financial statements (40% × $2.05 million).

<table>
<thead>
<tr>
<th>Description</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in B</td>
<td>820,000</td>
</tr>
<tr>
<td>CTA</td>
<td>820,000</td>
</tr>
</tbody>
</table>

The preceding is a simplified example illustrating an equity method investment in a newly formed, single foreign entity. If, at the time of acquisition, A had recognized goodwill or other fair value adjustments, such basis differences would be viewed as denominated in the foreign entity's (B's) functional currency. Thus, such amounts would be subject to translation and would affect the equity method investment balance the investor recognizes for the foreign entity. See Section 5.2.1.3 for more information.

5.3 Accounting for Exchange Differences Arising Upon Translation

**ASC 830-30**

45-12 If an entity's functional currency is a foreign currency, translation adjustments result from the process of translating that entity's financial statements into the reporting currency. Translation adjustments shall not be included in determining net income but shall be reported in other comprehensive income.

After performing the translation process, an entity records the resulting translation adjustments within the CTA, a separate component of OCI. The translation adjustment is initially deferred through OCI, since it is akin to an unrealized gain or loss that would only be realized under certain circumstances, as discussed in Section 5.4.

5.3.1 Allocation of CTA to Noncontrolling Interest

**ASC 830-30**

45-17 Accumulated translation adjustments attributable to noncontrolling interests shall be allocated to and reported as part of the noncontrolling interest in the consolidated reporting entity.

In determining whether a CTA can be attributed to noncontrolling interest (NCI) holders, the reporting entity should note that the CTA exists at the consolidated level as a result of differences between the subsidiary's functional currency and the reporting currency. Accordingly, the CTA is directly related to the parent entity's reporting currency and may not reflect the reporting currency of the NCI holders.
In light of these factors, we believe that in a manner consistent with the guidance in ASC 830-30-45-17 and the attribution guidance in ASC 810-10, a CTA should nonetheless be attributed to the partially owned subsidiary's NCI that gives rise to the adjustment. That is, the objective of NCI is to give investors of the consolidated entity visibility into how their claim on the net assets of a partially owned subsidiary changes from period to period.

Accordingly, we believe that it would be misleading to allocate to the controlling interest 100 percent of a CTA associated with a foreign, non-wholly-owned subsidiary that reflects the impact of changing currency rates on the subsidiary’s total net assets. Thus, it would be appropriate to allocate a proportionate amount of the CTA to NCI. For additional discussion, see Deloitte’s A Roadmap to Accounting for Noncontrolling Interests.

### Example 5-6 — Allocation of CTA to NCI

Parent Co is a multinational financial services company with global operations whose functional currency is the USD. Parent Co holds a controlling interest of 60 percent in Company ABC. The remaining 40 percent is held by a third party and represents an NCI.

Company ABC, which is located and operates in Germany, uses the EUR as its functional currency. Parent has determined that ABC is a foreign entity. There are no agreements in place that would govern allocations of ABC's income, loss, or OCI between Parent Co and the NCI in a manner that differs from their proportionate ownership interests.

At the end of 20X1, the translation of ABC's assets, liabilities, and operations from the EUR to the USD results in a CTA of $100 million. Of the $100 million, $40 million is allocated to the NCI in Parent Co's consolidated financial statements.

### 5.4 Release of CTA

ASC 830-30 includes guidance on the circumstances under which a CTA may be released, including scenarios involving (1) full and substantially complete liquidations and (2) partial sales and liquidations.

To apply the guidance in ASC 830-30, an entity needs to identify whether the sale or liquidation is related to an investment in a foreign entity or an investment within a foreign entity as well as whether the investment is consolidated or accounted for under the equity method. An investment in a foreign entity is typically reflected via a direct ownership interest in the foreign entity. By contrast, an investment within a foreign entity reflects the net assets or ownership of the foreign entity and is indirect.

### Example 5-7 — Distinguishing Between an Investment in and an Investment Within a Foreign Entity

Company A owns 80 percent of the equity interest in Company B, a foreign entity that owns various real estate properties.

Company A has an 80 percent investment in B, whose real estate properties represent an investment within B. Upon a disposition of B's real estate properties, while there would be a change in the investment within B from A’s perspective, the investment in B (i.e., the 80 percent ownership interest) would remain unchanged. Conversely, if A sold its direct equity interest in B, there would be a change to the investment in B.
The table below provides an overview of these distinctions and the related impact on the treatment of CTA. The transactions will be discussed further below in the sections indicated in the table.

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Change</th>
<th>Treatment of CTA</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>When the foreign entity is consolidated or combined:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of an investment in a foreign entity</td>
<td>Loss of control.</td>
<td>CTA is released.</td>
<td>5.4.1.1</td>
</tr>
<tr>
<td>Sale of part of an investment in a foreign entity</td>
<td>Ownership is reduced but control is maintained.</td>
<td>CTA is not released.</td>
<td>5.4.1.3</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Allocation of CTA to NCI may change and is accounted for in accordance with ASC 810-10-45-23 and 45-24.</td>
<td></td>
</tr>
<tr>
<td>Sale of an investment within a foreign entity</td>
<td>Reduction of the foreign entity's net assets.</td>
<td>CTA is not released unless the sale results in a complete or substantially complete liquidation.</td>
<td>5.4.2</td>
</tr>
<tr>
<td><strong>When the foreign entity is accounted for as an equity method investment:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional investment in a foreign entity, which qualifies as a step acquisition (see ASC 805-10-25-9 and 25-10).</td>
<td>Control is obtained.</td>
<td>CTA is released.</td>
<td>5.4.1.2</td>
</tr>
<tr>
<td>Sale of an equity method investment in a foreign entity</td>
<td>Ownership is reduced and significant influence is maintained.</td>
<td>CTA is released on a pro rata basis.</td>
<td>5.4.1.3</td>
</tr>
<tr>
<td>Sale of an investment, or part of an investment, in a foreign entity</td>
<td>Ownership is reduced and significant influence is lost.</td>
<td>CTA is released on a pro rata basis. Any CTA remaining after the release will become part of the carrying value of the remaining investment in a manner consistent with ASC 323-10-35-37 through 35-39.</td>
<td>5.4.1.3</td>
</tr>
<tr>
<td>Sale of an investment within a foreign entity</td>
<td>Reduction of the foreign entity's net assets.</td>
<td>CTA is not released unless the sale results in a complete or substantially complete liquidation.</td>
<td>5.4.2</td>
</tr>
</tbody>
</table>

5.4.1 Sales and Liquidations of Investments in a Foreign Entity

ASC 830-30

40-1 Upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity, the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be both:

a. Removed from the separate component of equity
b. Reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs.
5.4.1.1 Loss of Control of an Investment in a Foreign Entity

A loss of control of an investment in a foreign entity would trigger a deconsolidation in accordance with ASC 810-10. In a manner consistent with ASC 830-30-40-1A, such a deconsolidation would be treated as a sale of the investment in the foreign entity and a release of the CTA would be required irrespective of whether an NCI is retained.

Example 5-8 — Sale of a Wholly Owned Investment in a Foreign Entity in Which the Parent Ceases to Have a Controlling Financial Interest

Company Z, a parent company, has held a 100 percent ownership interest in Company X for a number of years. Company X is a foreign entity, and a $4 million CTA related to X has been recognized in OCI and accumulated.

On December 31, 20X1, Z sells a 60 percent ownership interest in X. As a result of the sale, Z's ownership interest is reduced to 40 percent and Z ceases to have a controlling financial interest in X. Company Z accounts for its remaining 40 percent ownership interest in X under the equity method, since it has retained significant influence over X.

When an entity loses control of a subsidiary that includes an investment in a foreign entity, such a loss of control is accounted for as a “sale” under ASC 830-30 irrespective of whether the entity retains an interest in the former subsidiary. Consequently, the CTA related to X, previously recognized in OCI and accumulated in equity, is fully reclassified from equity to gain or loss at the time of deconsolidation.

Example 5-9 — Sale of a Partially Owned Investment in a Foreign Entity in Which the Parent Ceases to Have a Controlling Financial Interest

Company Z, a parent company, has held an 80 percent ownership interest in Company X for a number of years. Company X is a foreign entity, and a $4 million CTA related to X has been recognized in OCI. Of this balance, $3.2 million was attributed to the controlling interest and $0.8 million was attributed to the NCI holders.

On December 31, 20X1, Z sells a 40 percent ownership interest in X. As a result of the sale, Z's ownership interest is reduced to 40 percent and Z ceases to have a controlling financial interest in X. Company Z accounts for its remaining 40 percent ownership interest in X under the equity method, since it has retained significant influence over X.

As illustrated in Example 5-8, regardless of Z’s continuing influence over X, all of the CTA associated with X must be released from AOCI. Therefore, in accordance with ASC 830-30-40-1A, the CTA associated with Z’s ownership of X ($3.2 million) is reclassified from equity to gain or loss. The CTA attributable to the NCI holders ($0.8 million) would already have been reflected as part of the NCI in the consolidated financial statements and would therefore be included in the gain or loss calculation on disposal of X (in accordance with ASC 810-10-40).
**5.4.1.2 Gain of Control of an Investment in a Foreign Entity**

Under ASC 830-30-40-1A(b), CTA is released when an acquirer obtains “control of an acquiree in which it held an equity interest, accounted for as an equity method investment that is a foreign entity, immediately before the acquisition date in a business combination achieved in stages.”

ASC 805-10-25-10 also discusses this concept, stating in part:

> If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

Therefore, a business combination achieved in stages is viewed as the equivalent of a disposition of the equity method investment in a foreign entity and the acquisition of a controlling financial interest in a foreign entity.

By contrast, a release of an existing CTA would not be permitted for acquisitions that increase the ownership interest of (1) an already consolidated foreign entity or (2) a foreign-entity equity method investee in the absence of a change of control.

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**Example 5-10 — Obtaining a Controlling Financial Interest in a Foreign Entity Through a Step Acquisition**

Company A, a U.S. company, holds a 45 percent ownership interest in B, a foreign entity, which it accounts for under the equity method. After its initial investment, A acquires an additional 40 percent ownership interest — and therefore obtains a controlling financial interest — in B. As of the acquisition date, A’s CTA recorded in AOCI for its investment in B is $100,000.

Upon obtaining a controlling financial interest in B, A should release 100 percent of the CTA balance into earnings. The accounting for obtaining the controlling interest is based on a view that the transaction reflects two separate and distinct events: (1) the disposition of A’s equity method investment and (2) A’s acquisition of a controlling financial interest. When a reporting entity disposes of a foreign entity, it must reclassify any related CTA in earnings, as contemplated in ASC 830-30. In this example, A “disposed of” its equity method investment in B; all of the related CTA therefore would be released into earnings.

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**5.4.1.3 Partial Sale of an Investment in a Foreign Entity**

ASC 830-30

40-2 If a reporting entity sells part of its ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the accumulated translation adjustment component of equity attributable to that equity method investment shall be recognized in measuring the gain or loss on the sale. If the sale of part of an equity method investment that is a foreign entity results in the loss of significant influence, see paragraphs 323-10-35-37 through 35-39 for guidance on how to account for the pro rata portion of the accumulated translation adjustment component of equity attributable to the remaining investment. For guidance if an entity sells a noncontrolling interest in a consolidated foreign entity, but still retains a controlling financial interest in the foreign entity, see paragraph 810-10-45-23 through 45-24.

For the sale of an NCI in a foreign entity that is combined or consolidated and for which the parent does not lose control as a result of the partial sale, the change in ownership interest should be accounted for in accordance with ASC 810-10-45-23 and 45-24. Accordingly, an acquisition or sale of any NCI should be accounted for as an equity transaction, with any difference in price paid, and the carrying amount of the NCI reflected, directly in equity and not in net income as a gain or loss. (For more information, see
Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.) Further, the CTA should be reallocated between controlling interest and NCI to reflect the revised ownership interest.

For partial sales of an investment in a foreign entity that is accounted for as an equity method investment, when the parent retains significant influence over the foreign entity, the CTA should be released into earnings on a pro rata basis. If the parent loses significant influence (i.e., its investment is subsequently accounted for under the cost method), any CTA remaining after the pro rata release into earnings should become part of the carrying value of the remaining investment, provided that the carrying value is not reduced below zero. In a manner consistent with ASC 323-10-35-37 through 35-39, if such reclassification would result in a carrying value that is less than zero, the carrying value should be adjusted to zero, with the remaining balance recognized through earnings.

**Changing Lanes**

Upon adopting ASU 2016-01, entities will no longer be permitted to account for investments in certain equity securities that are within the standard’s scope at cost. Instead, such securities will generally be accounted for at fair value, with changes in fair value recognized in net income. An exception to this requirement is that the ASU permits entities to measure certain qualifying equity securities without a readily determinable fair value at cost minus impairment, adjusted for changes in qualifying observable prices.

As a result, while there would be no change to the requirement in ASC 323 and ASC 830 to treat the remaining CTA as an adjustment to the carrying value of the investment upon a loss of significant influence, for those instruments that must be measured at fair value, it would in effect result in the release of the entire amount of CTA through earnings upon a loss of significant influence.

**Example 5-11 — Sale of an Equity Method Investment in a Foreign Entity in Which Significant Influence Is Retained**

Company I has held a 40 percent interest in an equity method investee, Company B, for a number of years. Company B is a foreign entity, and a $1 million CTA related to B has been recognized in OCI.

Company I disposes of 25 percent of its interest in B but retains significant influence through its remaining holding. Under ASC 830-30-40-2, when an investor disposes of part of its interest in an equity method investee that is a foreign entity but retains significant influence over that investee, the investor must reclassify to earnings the pro rata share of the CTA deferred in AOCI.

Consequently, in this example, 25 percent of the CTA (i.e., $250,000) must be reclassified from CTA to earnings on the transaction date.

**Example 5-12 — Sale of an Equity Method Investment in a Foreign Entity (Loss of Significant Influence)**

Company I has held a 40 percent interest in an equity method investee, Company B, for a number of years. Company B is a foreign entity, and a $400,000 CTA related to B has been recognized in OCI.

Company I disposes of 75 percent of its interest in B. Company I has determined that it no longer has significant influence over B and will account for its remaining interest as a cost method investment.
Example 5-12 — Sale of an Equity Method Investment in a Foreign Entity (Loss of Significant Influence) (continued)

Under ASC 830-30-40-2, when an investor sells part of its equity method investment in a foreign entity and loses significant influence over that investee, the investor must reclassify to earnings the pro rata share of the CTA deferred in AOCI. The remaining CTA should be accounted for in accordance with ASC 323-10-35-37 through 35-39. That is, the remaining CTA should be reclassified as part of the carrying value of the cost method investment. To the extent that the CTA balance offset would result in a carrying value of the cost investment of less than zero, the excess amount must be recorded in earnings.

Consequently, in this example, 75 percent of the CTA ($300,000) is reclassified from CTA to earnings on the sale date and the remaining CTA balance ($100,000) should be included in the carrying value of the remaining investment.

Example 5-13 — Partial Sale of an Investment in a Foreign Entity in Which the Parent Retains a Controlling Financial Interest

Company P, a parent company, has held a 100 percent interest in a subsidiary, Company S, for a number of years. Company S is a foreign entity, and a $2.5 million CTA related to S has been recognized in OCI. Company P sells 20 percent of its ownership interest in S but retains control over S.

Under ASC 810-10-45-24, when a parent disposes of part of its interest in a subsidiary that is a foreign entity but retains control of that subsidiary, “the carrying amount of [CTA] must be adjusted to reflect the change in ownership interest . . . through a corresponding charge or credit to equity attributable to the parent”; in such cases, the CTA would not be released into earnings.

Consequently, in this example, 20 percent of the CTA (i.e., $500,000) is transferred within equity from CTA to the NCI on the transaction date. No amounts are reclassified to earnings.

Example 5-14 — Impact of a Change in Functional Currency on Release of CTA

Parent Co is a U.S. entity that has investments in various foreign entities. Each foreign entity has determined that its local currency is its appropriate functional currency, while Parent Co’s functional currency is the USD.

If, during the year, the functional currency of one of the foreign subsidiaries changes, a release of the CTA into earnings would not be triggered. A change in functional currency does not trigger a release of the CTA into earnings regardless of whether the change is to the reporting currency or another foreign currency. As noted in ASC 830-30-40-1, only the sale, or complete or substantially complete liquidation, of a foreign subsidiary would trigger a release of the portion of the CTA attributable to that subsidiary into earnings (as part of the gain or loss on sale or liquidation of the investment in the subsidiary). See Section 2.4 for additional discussion of the accounting for a change in functional currency.

5.4.2 Sales and Liquidations of Investments Within Foreign Entities

ASC 830-30

40-3 Although partial liquidations by a parent of net assets held within a foreign entity may be considered similar to a sale of part of an ownership interest in the foreign entity if the liquidation proceeds are distributed to the parent, extending pro rata recognition (release of the cumulative translation adjustment into net income) to such partial liquidations would require that their substance be distinguished from ordinary dividends. Such a distinction is neither possible nor desirable. For those partial liquidations, no cumulative translation adjustment is released into net income until the criteria in paragraph 830-30-40-1 are met.
When a parent liquidates net assets within a foreign entity, the appropriate accounting depends on whether the derecognition results in a complete or substantially complete liquidation of the foreign entity.

To qualify as a substantially complete liquidation, generally 90 percent or more of the net assets of a foreign entity should be liquidated. Further, the term “liquidate” means that any proceeds received have been transferred out of the liquidated foreign entity. If an entity's sale of substantially all the net assets of one foreign entity is followed by a reinvestment in the same type of business and in the same location, we believe the transaction would not qualify as a liquidation.

If the transaction results in a complete or substantially complete liquidation of a foreign entity, 100 percent of the CTA should be released into earnings. If the transaction does not result in a complete or substantially complete liquidation of a foreign entity, no adjustments to the CTA should be recorded.

**Example 5-15 — Sale of a Second-Tier Subsidiary**

Company A, a U.S. entity, has a wholly owned subsidiary, B, that is located in the United Kingdom. In turn, B has a wholly owned subsidiary, C, that is located in the same country. Subsidiaries B and C are considered to be a single foreign entity in accordance with ASC 830. On December 1, 20X1, C is sold to Company D, an unrelated third party, and the proceeds from the sale are remitted to A.

The CTA balance related to A's investment in C should not be released into earnings unless the sale represents a substantially complete liquidation of the foreign entity that C had previously been part of. Therefore, if C represents 90 percent or more of the total net assets of the entire foreign entity, it would be appropriate to release the CTA related to the foreign entity into earnings.

**Example 5-16 — Sale of an Asset Group Within a Foreign Entity**

Company A has a wholly owned subsidiary, B, that is located in the United Kingdom and is considered a foreign entity under ASC 830. On December 1, 20X1, B sells an asset group that represents 95 percent of B's total net assets. The proceeds received from the sale of the asset group are retained and reinvested in B.

In this scenario, although the asset group disposed of constitutes over 90 percent of the net assets of B, no CTA should be released into earnings because the proceeds were reinvested in the foreign entity. Therefore, B's assets were merely recharacterized as a result of the disposition and the transaction would not be considered a substantially complete liquidation. Further, while the asset group sold by B may represent a business as defined in the Codification, this is irrelevant (i.e., business versus asset) to the determination of whether a CTA should be released to earnings upon the sale. Rather, as noted above, the determining factor is whether the transaction results in a sale or a complete or substantially complete liquidation of the foreign entity.
Example 5-17 — Annual Dividends Equal to Foreign Subsidiary’s Net Income

Company A has a wholly owned subsidiary, B, that is a foreign entity under ASC 830. Company B makes a dividend payment to A that is equal to B’s net income on an annual basis.

The payment of an annual dividend that is equal to the foreign subsidiary’s net income does not qualify as a sale or a complete or substantially complete liquidation of the foreign entity in accordance with ASC 830-30-40-1. Therefore, the payment does not trigger a release of the CTA to earnings.

Conversely, if B had paid a dividend that resulted in its complete or substantially complete liquidation, the reclassification of the CTA to earnings would be appropriate.

Example 5-18 — Determining Whether Reduction of a Long-Term Advance Triggers Recognition of a CTA in Earnings

A U.S. company, A, has an investment in a wholly owned U.K. subsidiary, B, to which it has made certain intercompany advances. The intercompany advances are denominated in GBP, the functional currency of B, and are considered a long-term investment under ASC 830-20-35-3(b). Company A, therefore, has not recognized transaction gains or losses related to the intercompany advances for the differences in the exchange rate between the USD and GBP; instead, A has recorded these differences in the same manner as translation adjustments (i.e., as a CTA).

For reasons that were previously not planned or anticipated, B wishes to reduce the amount of the long-term advances; however, A is not completely or substantially liquidating its investment in B.

A reduction in the long-term advance will not affect the CTA already recorded by A. The CTA balance should not be released into earnings until A's investment in B is sold or substantially or completely liquidated.

If the remaining advance continues to be long-term (i.e., only the amount of the intercompany advance has changed), A would continue to recognize transaction gains or losses associated with that investment in CTA for the portion of the advance that is considered long-term. If, after modification, the long-term advance no longer meets the requirements in ASC 830-20-35-3(b) for a long-term investment, future transaction gains or losses related to the advance will be recognized in earnings along with any other transaction gains or losses associated with any of A’s foreign-currency-denominated receivables or payables.

For additional information on qualifying and accounting for a long-term investment, see Section 6.4.

Example 5-19 — Changing the Form of a Long-Term Investment in a Foreign Subsidiary

Company O, a U.S. company, has a Canadian subsidiary to which it has made advances that are denominated in CAD. Company O has previously asserted that the advances are intended to be a long-term investment; therefore, in accordance with ASC 830-20-35-3, transaction gains and losses related to the advances have been recorded in the same manner as translation adjustments. There have been no previous repayments of the advances.

Because the value of the CAD has decreased against the USD, the value of the advances has also declined. To receive a tax deduction in the United States for the decrease, the advances would need to be repaid. Accordingly, O proposes to make a capital (cash) contribution to its Canadian subsidiary that the subsidiary can use to repay the advances.
Example 5-19 — Changing the Form of a Long-Term Investment in a Foreign Subsidiary (continued)

In the proposed transaction, O would not release the CTA that pertains to the advances into earnings. In the proposed transaction, O essentially is replacing one form of long-term investment with another form of investment. In accordance with ASC 830-30-40-1, the translation adjustment attributable to the long-term intercompany advances should remain a component of CTA until the Canadian subsidiary is sold or is completely or substantially liquidated. The settlement of intercompany transactions for which settlement was previously not planned or anticipated was addressed by the FASB 52 Implementation Group at its December 21, 1981, meeting. The group stated:

If a transaction is settled for which settlement was not planned or anticipated, the amount included in the special component of equity (applicable to the period for which settlement was not planned or anticipated) probably should remain there.

Further, the FASB staff has agreed with the conclusion that the translation adjustment included in equity should remain there until the foreign entity is sold or is completely or substantially liquidated.

For additional information on qualifying and accounting for a long-term investment, see Section 6.4.

5.4.3 Common-Control Transactions

While neither ASC 805 nor ASC 830 specifically addresses how to consider CTAs in the context of a common-control transaction, the release of CTAs through earnings related to such a transaction would generally be inconsistent with the principles of ASC 805-50-30-5.

The principles of ASC 805 imply that to release a CTA into earnings on a consolidated basis, the requirements of ASC 830-30 need to be met from the consolidated perspective of each reporting entity. Accordingly, the common-control principles may have a greater effect on multinational corporations that contain multiple reporting entities; in such cases, an entity may be required to track CTAs by originating foreign entity.

Additional complexity may arise when a common-control transaction, such as a restructuring or spinoff, results in a change in the functional currency of the foreign entity. When the functional currency changes, an entity would consider the guidance in ASC 830-10-45-10. In such cases, a freeze of the CTA would be required and its release would not be triggered (see Section 2.4.2 for additional discussion), potentially resulting in a scenario in which frozen CTA is recognized on a consolidated basis for a now domestic currency entity. Accordingly, it is important to track the CTA and the foreign entity that originated it.

Example 5-20 — Effect of Restructuring on CTA

Parent Co conducts its European operations through a U.S. legal entity. The European operations are segregated as a separate division (the “Division”) that is accounted for as a separate foreign entity under ASC 830. Parent Co’s functional currency is the USD, and the Division’s functional currency is the EUR. Parent Co has recognized a CTA balance of $3 million related to the Division in its consolidated financial statements as of December 31, 20X1.

Subsequently, Parent Co decided to restructure its operations. As a result, the Division’s operations will be sold from the U.S. legal entity to a newly created and wholly owned Swiss legal entity. This new Swiss legal entity will continue the Division’s operations.

In this example, since the new wholly owned Swiss legal entity continues the same operations, the reorganization is a change in legal organization but not a change in the consolidated entity (i.e., the entity is still owned and operated by Parent Co). Therefore, the CTA balance associated with the Division would not be released into earnings, since Parent Co has neither sold nor completely or substantially liquidated its investment in the Division.
5.4.4 Timing of Gain and Loss Recognition

**ASC 830-30**

40-4 Under Subtopic 225-20, a gain or loss on disposal of part or all of a net investment may be recognized in a period other than that in which actual sale or liquidation occurs. Paragraph 830-30-40-1 does not alter the period in which a gain or loss on sale or liquidation is recognized under existing generally accepted accounting principles (GAAP).

An entity determines the timing of the CTA release in accordance with the guidance in ASC 830-30. However, the timing for CTA release does not affect when gains or losses related to a sale or liquidation are recognized in accordance with other GAAP, nor does it affect when impairment losses are recognized, as discussed in Section 5.5.

**Example 5-21 — Discontinued Foreign Entities — Timing of Recognition of Foreign Currency Translation Adjustments in Net Income**

Company A has plans to sell its foreign subsidiary that represents a foreign entity. On December 31, 20X1, A’s investment in the foreign subsidiary is appropriately classified as held for sale and reported as a discontinued operation in accordance with ASC 205-20. The disposal of the foreign subsidiary is expected to occur in 20X2. On December 31, 20X1, there is an accumulated CTA balance of $1 million related to the foreign subsidiary.

While the subsidiary is classified as held for sale and reported as a discontinued operation, since the foreign subsidiary has neither been sold nor completely or substantially liquidated as of December 31, 20X1, it is not appropriate to reclassify any related CTA to earnings until such a sale or liquidation occurs in accordance with ASC 830-30-40-1.

However, A should consider the guidance in ASC 830-30-45-13 through 45-15 when analyzing its investment in the foreign subsidiary for potential impairment. See Section 5.5 for further discussion.

5.5 Impairment Considerations Related to CTA

5.5.1 Impairment and CTA

**ASC 830-30**

45-13 An entity that has committed to a plan that will cause the cumulative translation adjustment for an equity method investment or a consolidated investment in a foreign entity to be reclassified to earnings shall include the cumulative translation adjustment as part of the carrying amount of the investment when evaluating that investment for impairment. The scope of this guidance includes an investment in a foreign entity that is either consolidated by the reporting entity or accounted for by the reporting entity using the equity method. This guidance does not address either of the following:

a. Whether the cumulative translation adjustment shall be included in the carrying amount of the investment when assessing impairment for an investment in a foreign entity when the reporting entity does not plan to dispose of the investment (that is, the investment or related consolidated assets are held for use)

b. Planned transactions involving foreign investments that, when consummated, will not cause a reclassification of some amount of the cumulative translation adjustment.

45-14 In both cases, paragraph 830-30-40-1 is clear that no basis exists to include the cumulative translation adjustment in an impairment assessment if that assessment does not contemplate a planned sale or liquidation that will cause reclassification of some amount of the cumulative translation adjustment. (If the reclassification will be a partial amount of the cumulative translation adjustment, this guidance contemplates only the cumulative translation adjustment amount subject to reclassification pursuant to paragraphs 830-30-40-2 through 40-4.)
An entity shall include the portion of the cumulative translation adjustment that represents a gain or loss from an effective hedge of the net investment in a foreign operation as part of the carrying amount of the investment when evaluating that investment for impairment.

In accordance with the guidance above, an entity would not consider a CTA balance in an impairment assessment unless it has a clear plan to sell or liquidate the investment in a manner that would trigger the CTA release into earnings, as outlined in Section 5.4. In the absence of such a plan, the realization of the CTA would not be expected and the entity would therefore have no basis for including the CTA balance when assessing the impairment loss.

Further, while the above guidance may indicate that the CTA balance should be included in the measurement of the impairment loss in certain situations, such amounts recorded in CTA would not be released into earnings until the conditions noted in Section 5.4 have been met. As a result, there may be a timing lag between when the impairment loss is measured and recognized and when the CTA is released from AOCI into earnings.

Connecting the Dots

When the CTA associated with a foreign entity is included in the measurement of an impairment loss and is in a cumulative loss position (i.e., cumulative debit CTA), questions have arisen regarding whether the loss that is recognized on the impairment should be limited to the carrying amount of the investment (i.e., excluding amounts in AOCI) given that the CTA cannot be reclassified to earnings until the sale or substantial or complete liquidation of the foreign entity.

We believe that two approaches have been accepted in practice by analogy to a speech by Adam Brown, a professional accounting fellow, at the 2008 AICPA Conference on SEC and PCAOB Developments. By analogy to Mr. Brown's speech, the use of either of the following two approaches may be considered in a scenario in which a loss in excess of an asset's carrying amount is expected: (1) recognize an impairment loss in excess of the carrying value of the disposal group, thereby establishing a valuation allowance until the CTA may be released into earnings, or (2) limit the impairment loss to the carrying value of the disposal group.

The selected approach should be applied consistently as an accounting policy election to all similar transactions.

Example 5-22 — Treatment of OCI in Impairment Test for a Discontinued Operation

Company P, the parent company, has a wholly owned subsidiary that is a foreign entity, Company S. Company P has unrealized CTA gains of approximately $90 million that are reported in AOCI in relation to S and carries its investment in S at $386 million.

Company P has initiated a plan to sell its investment in S for $261 million. While the transaction is expected to close in January 20X2, P has determined that its investment in S meets all of the criteria in ASC 360-10-45-9 through 45-11 for classification as held for sale and for the results of its operations to be reported as a discontinued operation in P's consolidated financial statements as of December 31, 20X1.
Example 5-22 — Treatment of OCI in Impairment Test for a Discontinued Operation (continued)

In this example, P would include the unrealized CTA gain in the carrying amount of its investment in S when evaluating S for impairment in accordance with ASC 360-10-35-38 through 35-49; however, the balance recorded in CTA would not be released into earnings until the sale occurs and the conditions under ASC 830-30 are met. The following calculations illustrate the impairment loss assessment and subsequent accounting effects of this example in accordance with ASC 830-30-45-13:

<table>
<thead>
<tr>
<th>Impairment Assessment (in millions):</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount</td>
</tr>
<tr>
<td>Unrealized gains in CTA</td>
</tr>
<tr>
<td>Adjusted carrying amount</td>
</tr>
<tr>
<td>Expected selling price</td>
</tr>
<tr>
<td>Impairment loss</td>
</tr>
<tr>
<td>Investment carrying amount</td>
</tr>
<tr>
<td>Impairment write-down</td>
</tr>
<tr>
<td>New carrying amount</td>
</tr>
</tbody>
</table>

**Accounting Results at Date of Sale**

Sales proceeds                        | 261 |
Less investment carrying amount        | (351) |
OCI reclassification entry             | 90  |
Gain on sale                           | —   |

### 5.5.2 Abandonment and CTA

In the context of a plan to abandon a foreign entity, the principles of ASC 830-30 continue to apply to the determination of whether the criteria allowing for the inclusion of the CTA in the impairment assessment are met. Accordingly, it is necessary to consider what is being abandoned in the context of the foreign entity as well as what the abandonment would entail, which would further affect the timing of the CTA release, as noted in Section 5.4.

Example 5-23 — Accounting for Currency Translation Adjustments in Abandonment of an Investment in a Foreign Entity

Company A has a wholly owned foreign subsidiary that is a foreign entity, Company X. In connection with its investment in X, A has unrealized translation gains and losses within CTA in its consolidated financial statements. In the fourth quarter of 20X1, A states its intent to abandon its investment in X as soon as practicable in 20X2 and has a plan in place to have all of X’s facilities and offices closed by March 1, 20X2. Concurrently with this decision, A records an impairment loss for its investment in X in accordance with ASC 360.
Example 5-23 — Accounting for Currency Translation Adjustments in Abandonment of an Investment in a Foreign Entity (continued)

In this scenario, the CTA balance should not be released from AOCI into earnings until X's facilities and offices have been closed (i.e., on March 1, 20X2) and, in essence, abandoned. ASC 360-10-35-47 states, in part, that a “long-lived asset to be abandoned is disposed of when it ceases to be used.” Before this time, it would not be appropriate to recognize the release of CTA associated with the abandoned investment, in accordance with ASC 830-30-40-1, which states that CTA is released into earnings “[u]pon sale or upon complete or substantially complete liquidation of an investment in a foreign entity.” The abandonment of X is akin to a sale or liquidation of X, since X would cease to exist as an operating subsidiary of A and would no longer provide future benefits to A after the abandonment.

The CTA should be included in the carrying amount of A’s investment in the foreign subsidiary in the evaluation of that investment for impairment under ASC 830-30-45-13.
Chapter 6 — Intra-Entity Transactions

6.1 Chapter Overview
Intra-entity foreign currency transactions can have unique effects on an entity's financial statements, including the (1) creation and transfer of foreign currency risk from one entity in a consolidated group to another, (2) creation of transaction gains and losses that “survive” consolidation, and (3) application of exceptions to the general rules outlined in ASC 830. This chapter discusses the accounting effects of intra-entity transactions.

6.2 Intra-Entity Transactions Arising in the Normal Course of Business

**ASC 830-20**

<table>
<thead>
<tr>
<th>Transaction Gains and Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-1</strong> A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes.</td>
</tr>
</tbody>
</table>

| **35-2** At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date. Paragraphs 830-20-30-2 through 30-3 provide more information about exchange rates. |

Entities often regularly transact with other entities (e.g., the parent entity or other subsidiaries) within their consolidated group (e.g., through the sale or purchase of inventory). When the entities that are party to such transactions have different functional currencies, transaction gains and losses may result, just as they do when similar transactions are entered into with outside parties (see Chapter 4). Under ASC 830-20-35-1 and 35-2, transaction gains and losses associated with transactions that are denominated in a currency other than the entity's functional currency should be included in earnings unless they meet any of the criteria in ASC 830-20-35-3, as discussed in Section 6.3 below. Although the related intra-entity payable or receivable will be eliminated upon consolidation, the transaction gain or loss “survives” consolidation because it results in (or will result in) actual changes to the entity's cash flows.
For example, in the preparation of the foreign entity's functional-currency financial results, intra-entity transactions between a parent entity and a foreign entity that are denominated in the parent's functional currency are subject to the measurement guidance in ASC 830-20; as a result, a transaction gain or loss may be recognized in the foreign entity's earnings. However, upon consolidation, the foreign entity's financial results would be subject to ASC 830-30 and translated, with the resulting translation adjustment reflected in the consolidated entity's CTA. In such situations, the transaction gain or loss recognized by the foreign entity would not be eliminated upon consolidation. This would also be the case when an intra-entity transaction is denominated in the foreign entity's functional currency, resulting in the recognition by the parent (instead of the foreign entity investee) of a transaction gain or loss that would not be eliminated upon consolidation.

**Example 6-1 — Foreign-Currency-Denominated Intra-Entity Payables Arising in the Normal Course of Business**

Company J, an entity whose functional currency is the USD, has a wholly owned Mexican subsidiary, M. Management of M previously determined that the MXN is its functional currency, primarily because M's sales to third parties, as well as its labor costs, are denominated in this currency. Purchases of raw materials from J are denominated in USD, and the related intra-entity payables to J are therefore denominated in USD as well.

In the absence of contemporaneous evidence to the contrary, payables arising through the ordinary course of business are expected to be settled in the foreseeable future. Therefore, such balances should be accounted for in the same manner as similar transactions with outside parties (as discussed in Example 4-2 in Chapter 4).

Upon consolidation, the intra-entity payable (on M's books) and receivable (on J's books) would be eliminated. However, any exchange rate fluctuations that result in transaction gains and losses on M's books in connection with the USD-denominated payables would not be eliminated but would “survive” consolidation and be reflected in earnings.

However, if M negotiates a long-term advance with its parent, J, for which repayment is neither planned nor anticipated in the foreseeable future, gains or losses resulting from future foreign currency fluctuations may be accounted for prospectively from the date of the negotiated advance or note payable in a manner similar to translation adjustments. See Section 6.4 for discussion related to intra-entity accounts that are long-term in nature.

### 6.2.1 Unsettled Intra-Entity Transactions When Multiple Exchange Rates Exist

**ASC 830-30**

**Exchange Rates**

45-7 If unsettled intra-entity transactions are subject to and translated using preference or penalty rates, translation of foreign currency statements at the rate applicable to dividend remittances may cause a difference between intra-entity receivables and payables. Until that difference is eliminated by settlement of the intra-entity transaction, the difference shall be treated as a receivable or payable in the reporting entity's financial statements.

Generally, a foreign entity's financial statements should be translated by using the exchange rate that applies to dividend remittances (see Chapter 3). However, there may be different preference or penalty rates that apply to unsettled intercompany transactions. Differences between the dividend remittance rate and the preference or penalty rate could result in a receivable or payable (that survives consolidation) until the intra-entity balance is ultimately settled (and the differences are therefore eliminated).
6.3 Intra-Entity Profit

**Elimination of Intra-Entity Profits**

45-10 The elimination of intra-entity profits that are attributable to sales or other transfers between entities that are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements shall be based on the exchange rates at the dates of the sales or transfers. The use of reasonable approximations or averages is permitted.

As noted in the guidance above, intra-entity profits resulting from “sales or other transfers between entities that are consolidated, combined, or accounted for by the equity method” should be translated by using the exchange rate on the transaction date (or another appropriate alternative). For example, in the case of an intra-entity sale of inventory, any profit recognized by the selling entity would also be included in the inventory balance on the books of the purchasing entity and should be eliminated in consolidation until the inventory is sold to an outside party. Subsequent exchange rate fluctuations should not affect the intra-entity profit being eliminated.

Accordingly, an entity should track the portion of the inventory balance attributable to the intra-entity profit that originated on the transaction date and the portion attributable to the underlying cost of the inventory (i.e., the selling entity's cost basis). As noted above, the portion attributable to the intra-entity profit should be translated at the historical rate in effect on the date of the intra-entity sale. The portion attributable to the underlying cost component should be translated at the current exchange rate.

6.4 Long-Term Intra-Entity Transactions

**Transaction Gains and Losses to Be Excluded From Net Income**

35-3 Gains and losses on the following foreign currency transactions shall not be included in determining net income but shall be reported in the same manner as translation adjustments: . . .

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

35-4 Intra-entity transactions and balances for which settlement is not planned or anticipated in the foreseeable future are considered to be part of the net investment. This might include balances that take the form of an advance or a demand note payable provided that payment is not planned or anticipated in the foreseeable future.

A consolidated entity should pay particular attention to long-term intra-entity transactions, since the facts and circumstances associated with such transactions may result in an accounting treatment for the consolidated entity that is inconsistent with the general principles in ASC 830.

6.4.1 Meaning of “Foreseeable Future”

ASC 830-20-35-3(b) contains an exception that allows entities to recognize transaction gains or losses as a CTA within OCI for intra-entity transactions that are “of a long-term investment nature” (i.e., the settlement of such transactions “is not planned or anticipated in the foreseeable future”). Whether repayment is planned is a key factor in applying this exception.
The FASB 52 Implementation Group discussed this issue at its December 1981 meeting, concluding that the term “foreseeable future” does not imply a specific period but is an intent-based indicator. Specifically, the group noted that an intra-entity transaction may qualify for the ASC 830-20-35-3(b) exception if:

- There are no planned or anticipated repayments.\(^1\)
- Management, having the appropriate authority, represents that (1) it does not intend to require repayment of an intra-entity account and (2) the parent company’s management views the intra-entity account as part of its investment in the foreign subsidiary.

If the criteria for the exception are met, the transaction gains and losses are recorded through the CTA as if they were part of the net investment.

**Example 6-2 — Short-Term Intra-Entity Debt**

Company C is a wholly owned U.S. subsidiary (whose functional currency is the USD) of Company D, a Swiss-based holding company. Company C has notes due to D that are denominated in EUR. The notes have stated maturities ranging from six months to one year. Although the notes are short-term by contract, D represents each year that it will not demand payment for that year; historically, the notes have been renewed each year.

In this case, the short-term notes would not qualify for the exception in ASC 830-20-35-3(b). Company D only represents that it will not require payment in the current year on the rolled-over short-term notes; it does not represent that it will not demand payment on the notes in the foreseeable future (i.e., the timing of the repayment appears uncertain).

In other words, because D (the parent) cannot represent that repayment will not be required in the anticipated or foreseeable future, it is inappropriate for D to apply the exception in ASC 830-20-35-3(b). Further, the FASB 52 Implementation Group concluded that rolling- or minimum-balance intra-entity accounts do not qualify for this exception (see Example 6-4).

As demonstrated in the example above, uncertainty regarding the timing of a repayment is not a criterion under which a transaction can be considered long-term in nature. For an entity to apply the exception in ASC 830-20-35-3(b), there must not be a planned or anticipated repayment in the foreseeable future.

Conversely, an intra-entity loan or advance may have a stated maturity or be due on demand, but if the lending entity does not intend to demand repayment despite the maturity date (i.e., management has stated its intentions to renew the loan or advance), it may be acceptable to apply the exception. The appropriate accounting in such cases will depend on the management’s specific, stated intentions. In Example 6-3 below, an intra-entity loan may seem to be long-term in nature given management’s intentions but does not, in fact, qualify for the exception.

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\(^1\) An intra-entity transaction may qualify for the ASC 830-20-35-3(b) exception when a repayment is made, as long as the repayment was not planned or anticipated. The minutes of the December 1981 FASB 52 Implementation Group meeting state, in part, “If a transaction is settled for which settlement was not planned or anticipated, the amount included in the special component of equity (applicable to the period for which settlement was not planned or anticipated) probably should remain there.”
Example 6-3 — Determining Whether Linked Transactions Can Be Accounted for as Long-Term in Nature

Company A, which uses its local currency (EUR) as its functional currency, is a subsidiary of a U.S. parent company, P. Bank B has loaned A $100 million USD that is due in 20X4. Company A currently makes interest-only payments. The debt with B is collateralized in full with a letter of credit from P. Company A will most likely not be able to make its balloon payment (and possibly not its interest payments) under the existing agreement and will not be able to obtain alternative financing. Therefore, B is expected to convert the letter of credit in full payment of the debt as soon as A defaults. After default, P will have the third-party B debt and a USD-denominated intra-entity receivable from A. Company A will have a USD-denominated intra-entity payable to P.

In accordance with ASC 830-20-35-3(b), it is not acceptable for A to currently account for its debt to B as an intra-entity foreign currency transaction that is “of a long-term-investment nature” even though there is a high probability of default and conversion to an intra-entity payable is expected.

Company P’s settlement of A’s debt with B is anticipated in the near future with the creation of a new debt instrument also from P (its obligation under the letter of credit), and A will have an intra-entity payable to P. The settlement of A’s existing debt with B, the borrowing under the letter of credit, and the intra-entity transaction are not seen as one continuous transaction under ASC 830. Therefore, A’s debt to B does not currently meet the criteria to be reported in the same manner as a translation adjustment.

Because A currently makes USD-denominated interest payments to B, its functional currency cash flows are affected by changes in the foreign currency exchange rate. Changes in the foreign currency exchange rate affect A’s actual and expected functional currency cash flows. Therefore, the transaction gains and losses on such borrowings should continue to be accounted for as transaction gains and losses to be included in the determination of net income.

Management should also consider factors other than its intent in determining whether a transaction qualifies as long-term in nature. For instance, management should consider its history with similar instruments for which the intention was not to repay. If the entity, despite management’s intention, has historically been unable to maintain the long-term nature of similar instruments (e.g., repayments were necessary as a result of cash flow constraints), the entity may conclude that the instrument does not meet the “foreseeable future” criterion and that it cannot apply the exception. Other factors for an entity to consider in determining whether it qualifies for the exception are (1) its ability to control whether and, if so, when repayment will occur (e.g., if repayment is contingent on the occurrence of a certain event or transaction) and (2) whether there is a legitimate business purpose for not settling the intra-entity account. Further, when applying this exception, management should ensure that its intentions related to long-term intra-entity accounts are consistent with assertions being made for other purposes (e.g., indefinite reinvestment assertions for income tax purposes).

Connecting the Dots

The amounts subject to these long-term intra-entity transactions are often large enough that board approval is needed. An entity should therefore ensure that management personnel with the appropriate level of authority have approved the fact that the loans will not be repaid in the foreseeable future.
In addition, management should look for contradictory evidence regarding the assertion that the loans will not be repaid in the foreseeable future. For example, often these loans are created to generate an interest expense deduction in a high-tax-rate jurisdiction. Many tax jurisdictions require that an entity repay the loan at some point in time to receive the tax deduction. Accordingly, management will need to determine whether the assertion made for tax purposes (i.e., the intention to receive the deduction) contradicts the assertion made for financial reporting purposes (i.e., the settlement of such a transaction “is not planned or anticipated in the foreseeable future”). If the two assertions are contradictory, management will need to evaluate whether the deferral of foreign currency transaction gains and losses is appropriate or whether a tax reserve should be established for the interest deduction. See Deloitte’s *A Roadmap to Accounting for Income Taxes* for additional information on the tax accounting impacts of these types of transactions.

Note that the long-term-nature exception discussed above applies only to the consolidated entity’s financial statements. If an individual entity in the intra-entity transaction (e.g., a subsidiary) is required to compile stand-alone financial statements, the general rules in ASC 830 would apply and the transaction gains and losses associated with such accounts would be recorded in earnings.

Similarly, if an ultimate parent entity enters into an intra-entity advance or loan with a third-tier subsidiary that is consolidated into an intermediary subsidiary, the accounting for the transaction in the intermediary’s stand-alone, consolidated financial statements would not qualify for the exception because the transaction is between the intermediary’s subsidiary and an entity outside its stand-alone, consolidated group (i.e., its ultimate parent). The image below illustrates this concept.

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2 On October 13, 2016, the U.S. Treasury and the IRS released final and temporary regulations under Section 385 of the Internal Revenue Code that (1) “establish threshold documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for [U.S.] federal income tax purposes” and (2) “treat as stock certain related-party interests that otherwise would be treated as indebtedness for [U.S.] federal income tax purposes.” The regulations contain requirements related to documenting certain related-party debt instruments as a prerequisite to treating such instruments as debt. The rules generally require written documentation of the following four indebtedness factors: (1) the issuer’s unconditional obligation to pay a certain sum; (2) the holder’s rights as a creditor; (3) the issuer’s ability to repay the obligation; and (4) the issuer’s and holder’s actions demonstrating a debtor-creditor relationship, such as payments of interest or principal and actions taken on default. For more information on the regulations, see Deloitte’s October 14, 2016, *United States Tax Alert*. 

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Accounts that are not determined to be long-term in nature (and are therefore subject to the same accounting treatment as similar accounts with third parties) will expose the entity to foreign currency exchange rate fluctuations since the effects of such fluctuations are reported in earnings.

6.4.2 Intra-Entity Debt With Interest Payments

If an intra-entity debt instrument is determined to be long-term in nature in accordance with the guidance discussed above, any related interest receivable or payable would not qualify for the same exception as the debt instrument itself when periodic interest payments are required. Rather, any transaction gains or losses related to the interest receivable or payable would be recorded in earnings (and would not be reclassified into a CTA upon consolidation). Such gains and losses would survive consolidation in a manner consistent with those that occur in the normal course of business (as discussed in Section 6.2 above).

6.4.3 Rolling or Minimum Balances

Many parent entities will maintain a minimum balance when managing intra-entity receivable or payable accounts. Management often views this minimum balance as a component in its financing of the subsidiary; however, rolling-balance and minimum-balance intra-entity accounts generally do not qualify for the exception for long-term investments under ASC 830.

### Example 6-4 — Rolling or Minimum Balances Viewed as Long-Term Investments

Company A, whose functional currency is the USD, advances EUR to its foreign subsidiary, AB, which has identified the EUR as its functional currency. Subsidiary AB may repay some of the advances; generally, however, they are replaced with new advances within a short time frame (i.e., three to five days). In total, AB has 50 million EUR advances outstanding at all times.

The advances from A to AB do not qualify as a long-term investment under ASC 830-20-35-3(b). Company A should therefore recognize transaction gains or losses related to such advances in earnings.

The FASB 52 Implementation Group addressed a similar question at its December 1981 meeting, concluding that the “aggregate balance of trade receivables or payables (each open invoice will be settled) cannot qualify as a long-term investment.” The group further concluded that intra-entity transactions must be evaluated individually, not on an aggregate or net basis (i.e., even if all intra-entity balances are aggregated in one general ledger account, an entity must consider the transactions individually to determine which ones qualify as long-term in nature).

6.4.4 Parent's Guarantee of a Foreign Subsidiary's Debt

Like the linked transaction in Example 6-3, a parent company's guarantee of a subsidiary's debt (either through contribution of equity or intra-entity lending) does not qualify for the long-term investment exception in ASC 830-20-35-3(b). Consider the following example:

### Example 6-5 — Parent's Guarantee of Foreign Subsidiary's Debt

Company AA, a U.S. company, has a Mexican subsidiary, BB, whose functional currency is the MXN. Subsidiary BB borrows USD from a U.S. bank, and AA guarantees repayment of the loan. Company AA could have provided an intra-entity loan to BB but decided not to do so for tax reasons. For tax reasons, BB, rather than AA, makes the interest payments. Subsidiary BB is not expected to repay the loan in the foreseeable future.
Chapter 6 — Intra-Entity Transactions

At its May 1982 meeting, the FASB 52 Implementation Group concluded that a parent company’s guarantee of a subsidiary’s foreign-currency-denominated debt does not meet the definition of a long-term investment. Therefore, in the example above, the Mexican subsidiary must recognize the transaction gains or losses in earnings for the USD-denominated debt.

6.4.4.1 Settling Foreign-Currency-Denominated Debt and Making a Long-Term Investment

In a manner consistent with the transactions described above, settlements of third-party debt through an intra-entity borrowing also should be accounted for as separate transactions as they occur. Therefore, any foreign currency adjustment associated with settlement of the debt should be recorded as a transaction gain or loss in the period in which the exchange rate changes, regardless of the nature of the intra-entity borrowing. However, if the intra-entity foreign currency transaction is determined to be of a long-term investment nature for which settlement is not planned or anticipated in the foreseeable future, future foreign currency adjustments associated with such an intra-entity loan may be accounted for as a translation adjustment in accordance with ASC 830-20-35-3(b).

Example 6-6 — Parent’s Settlement of Foreign Subsidiary’s Debt Through Intra-Entity Borrowing

Company M is a subsidiary of Company K. Company M’s functional currency is MXN, and K’s functional currency is the USD. Company M has third-party USD-denominated debt on its books for which it must recognize transaction gains and losses for the changes in the USD-to-MXN exchange rate. Company K agrees to repay M’s foreign-currency-denominated (i.e., USD-denominated) debt, and M will record an intercompany MXN-denominated payable to K.

In these circumstances, it would not be appropriate for M to record the foreign currency adjustment associated with settlement of the USD-denominated debt as a translation adjustment instead of as a foreign currency transaction gain or loss. Rather, the intercompany borrowing and settlement of third-party debt should be accounted for separately. Therefore, any foreign currency adjustment associated with settlement of the USD-denominated debt should be recorded as a transaction gain or loss in the period in which the exchange rate changes. However, if K and M enter into an intercompany foreign-currency transaction that is of a long-term investment nature for which settlement is not planned or anticipated in the foreseeable future, future foreign-currency adjustments associated with such an intercompany loan may be accounted for as a translation adjustment under ASC 830-20-35-3(b).

6.4.5 Settlements or Reductions of a Long-Term Advance

In certain circumstances, an entity may conclude that an intra-entity balance (or part of an intra-entity balance) that was previously (and appropriately) determined to be long-term in nature no longer qualifies as such. In such cases, the entity should, going forward, report transaction gains and losses in earnings; the transaction gains and losses previously reported in CTA should not be reversed or otherwise adjusted until “sale or complete or substantially complete liquidation of [the] investment in a foreign entity” in accordance with ASC 830-30-40-1. See Section 5.4 for additional discussion of the conditions for release of the gains and losses in CTA.

If only a portion of long-term advances is settled or reduced and the remaining intercompany advances continue to qualify as a long-term investment, the entity would continue to recognize in its CTA the transaction gains or losses arising from the portion of the advances that is still considered long-term. Example 5-16 demonstrates the appropriate accounting treatment in these circumstances.

3 For example, the United Kingdom’s recent decision to exit the European Union (known as “Brexit”) may result in entities reassessing their previously appropriate conclusions that certain intercompany balances with entities within the United Kingdom or the European Union are long-term in nature.
Chapter 6 — Intra-Entity Transactions

Note that this differs from the accounting treatment required when an intra-entity balance is forgiven, since forgiveness is consistent with the assertion that the amount was not intended to be settled. In such circumstances, transaction gains and losses up through the date on which the loan is legally forgiven or extinguished should continue to be recorded in CTA. Once forgiven, the balance of the loan should be reclassified as a capital contribution and no further transaction gains or losses should be recognized.

6.5 Intra-Entity Dividends

When a foreign subsidiary declares a dividend to its parent company and there is a significant time lag between the record date and the payment date, the parent would recognize transaction gains or losses related to the dividend receivable in earnings as it would for other transaction gains or losses related to foreign-currency-denominated assets or liabilities.\(^4\) If the U.S. parent's functional currency is the USD, a receivable denominated in a currency other than the dollar is a foreign currency transaction.

Similarly, a foreign subsidiary's declaration of a dividend, which is not paid on the date of declaration, results in a payable. If the payable is not denominated in the subsidiary's functional currency, the subsidiary is at risk for fluctuations in the foreign currency exchange rate between the declaration date and the date the exchange rate is fixed for the purpose of paying the dividend.

See Section 6.4.2 for additional guidance on the foreign exchange effects of declared dividends that are denominated in a foreign currency.

\(^4\) The FASB 52 Implementation Group addressed this issue in December 1981.
Chapter 7 — Highly Inflationary Economies

7.1 Chapter Overview
ASC 830 states that one of its objectives is for a reporting entity to “provide information that is generally compatible with the expected economic effects of a rate change on [the entity’s] cash flows and equity.” In providing such information, the entity needs to use a stable measuring unit (i.e., a stable currency).

In economies with significant inflation, the local currency may eventually be deemed instable. Although any degree of inflation may affect the usefulness of an entity’s financial statements, the higher the inflation rate, the less relevant historical costs become (i.e., historical values diminish over time and become smaller than similar costs incurred in a highly inflationary environment). Therefore, ASC 830 requires that entities operating in environments deemed to be highly inflationary remeasure their financial statements in the reporting currency.

This chapter discusses how to determine when highly inflationary conditions exist and the related accounting for a change in functional currency when an economy has been designated as highly inflationary.

7.2 Determining a Highly Inflationary Economy

<table>
<thead>
<tr>
<th>ASC 830-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-11 The financial statements of a foreign entity in a highly inflationary economy shall be remeasured as if the functional currency were the reporting currency. Accordingly, the financial statements of those entities shall be remeasured into the reporting currency according to the requirements of paragraph 830-10-45-17. For the purposes of this requirement, a highly inflationary economy is one that has cumulative inflation of approximately 100 percent or more over a 3-year period.</td>
</tr>
</tbody>
</table>

In determining whether it operates in a highly inflationary economy (i.e., one for which cumulative inflation is approximately 100 percent or higher over a three-year period), an entity may need to use judgment in addition to performing the cumulative inflation calculation. For example, when an economy’s cumulative inflation is approaching 100 percent, an entity must consider factors such as any relevant trends associated with the economy’s inflation rates. The Basis for Conclusions of FASB Statement 52 (codified in ASC 830) indicated that, in some cases, “the trend of inflation might be as important as the absolute rate” calculated in accordance with ASC 830-10.

However, this analysis is only necessary if an entity uses the highly inflationary economy’s currency as its functional currency. If another foreign currency is the functional currency, the entity is not considered to be operating in the local economy and therefore should only monitor the highly inflationary status of the economy related to its functional currency.
Chapter 7 — Highly Inflationary Economies

Example 7-1 — Functional Currency Is Not the Local Currency of a Highly Inflationary Economy

Company A is the subsidiary of a U.S.-based entity that is physically located in Country V. Upon its acquisition by the U.S.-based entity several years ago, A's management determined its functional currency to be the USD, and no significant changes in facts and circumstances have caused that determination to change.

In the current year, V's economy has been determined to be highly inflationary. Because A does not use V's local currency as its functional currency, V's designation as highly inflationary does not affect A's accounting records.

7.2.1 Calculating the Cumulative Inflation

ASC 830-10

45-12 The determination of a highly inflationary economy must begin by calculating the cumulative inflation rate for the three years that precede the beginning of the reporting period, including interim reporting periods. If that calculation results in a cumulative inflation rate in excess of 100 percent, the economy shall be considered highly inflationary in all instances. However, if that calculation results in the cumulative rate being less than 100 percent, historical inflation rate trends (increasing or decreasing) and other pertinent economic factors should be considered to determine whether such information suggests that classification of the economy as highly inflationary is appropriate. Projections cannot be used to overcome the presumption that an economy is highly inflationary if the 3-year cumulative rate exceeds 100 percent.

45-13 The definition of a highly inflationary economy is necessarily an arbitrary decision. In some instances, the trend of inflation might be as important as the absolute rate. The definition of a highly inflationary economy shall be applied with judgment.

45-14 Example 3 (see paragraph 830-10-55-23) illustrates the application of this guidance.

Example 3: Determination of a Highly Inflationary Economy

55-23 The following Cases illustrate the application of paragraph 830-10-45-12:

a. The cumulative 3-year inflation rate exceeds 100 percent (Case A).

b. The cumulative 3-year inflation rate drops below 100 percent but no evidence suggests that drop is other than temporary (Case B).

c. The cumulative 3-year inflation rate drops below 100 percent after having spiked above 100 percent (Case C).

Case A: Cumulative 3-Year Inflation Rate Exceeds 100 Percent

55-24 Country A's economy at the beginning of 19X9 continues to be classified as highly inflationary because the cumulative 3-year rate is in excess of 100 percent (see the following table). The recent trend of declining inflation rates should not be extrapolated to project future rates to overcome the classification that results from the calculation.

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

(a) Amounts are calculated as a compounded three-year inflation rate.
Case B: Cumulative 3-Year Inflation Rate Drops Below 100 Percent

55-25 Country B’s economy at the beginning of 19X9 should continue to be classified as highly inflationary even though the cumulative 3-year rate is less than 100 percent (see the following table) because there is no evidence to suggest that the drop below the 100 percent cumulative rate is other than temporary and the annual rate of inflation during the preceding 8 years has been high.

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

(a) Amounts are calculated as a compounded three-year inflation rate.

Case C: Cumulative 3-Year Inflation Rate Drops Below 100 Percent After Spike

55-26 Country C’s economy at the beginning of 19X9 should no longer be classified as highly inflationary because the cumulative 3-year rate is less than 100 percent (see the following table) and the historical inflation rates suggest that the prior classification resulted from an isolated spike in the annual inflation rate.

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

(a) Amounts are calculated as a compounded three-year inflation rate.

Although an entity may need to use some judgment in determining whether an economy is highly inflationary, it should begin the determination by calculating the cumulative inflation rate. As clarified in ASC 830-10-45-12 (originally issued as EITF Topic D-55), if the calculation (as described below) “results in a cumulative inflation rate in excess of 100 percent, the economy should be considered highly inflationary in all instances” (emphasis added). Further, ASC 830-10-45-12 states — and the examples in ASC 830-10-55-24 through 55-26 illustrate — that projections of future inflation rates “cannot be used to overcome the presumption that an economy is highly inflationary if the 3-year cumulative rate exceeds 100 percent.”

An entity should perform this assessment in each reporting period for the three-year period ending as of the beginning of its current reporting period (including interim periods). For example, calendar-year-end entities with interim reporting requirements should calculate a cumulative inflation rate at the end of each quarter on the basis of the inflationary information for the past 36 months.

Once the three-year period has been identified, an entity should determine the appropriate inflation rate or index to use for the cumulative-rate calculation. Although ASC 830 does not specify which rates or indices should be used, general indices or rates, such as those reported by the International Monetary Fund (IMF) or the Economist Intelligence Unit, are the most common ones employed. The rates or indices used for the analysis should generally be comprehensive (e.g., the comparable rate of the U.S. Consumer Price Index reported to the IMF by foreign governments) rather than industry- or entity-specific. For detailed instructions on obtaining inflationary information from the IMF’s Web site, see Section 7.2.2.
After identifying an appropriate rate or index, an entity must calculate the cumulative inflation rate for the most recent three-year period. ASC 830 does not specify whether period-end rates or average rates for the period should be used in the calculation of the cumulative inflation rate. In practice, entities may exercise judgment in selecting which method to use in calculating a cumulative rate as long as the method is applied consistently. Regardless of the method used, the FASB 52 Implementation Group concluded at its January 1982 meeting that the cumulative three-year inflation index should be calculated on a compounded basis (an annual rate of approximately 26 percent, when compounded, will result in a cumulative inflation rate of 100 percent).

The cases in ASC 830-10-55-24 through 55-26 illustrate how to calculate cumulative inflation on a compounded basis. For example, the table below, adapted from Case A in ASC 830-10-55-24, shows the annual rate and cumulative three-year rate for the first three years.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>X1</th>
<th>X2</th>
<th>X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual inflation rate</td>
<td>9%</td>
<td>8%</td>
<td>12%</td>
</tr>
<tr>
<td>Cumulative three-year rate</td>
<td>32%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In this scenario, an entity would perform the following steps in calculating the cumulative inflation rate on a compound basis:

1. $1.09 \times 1.08 = 1.18$
2. $1.18 \times 1.12 = 1.32$
3. $(1.32 - 1.0) \times 100\% = 32\%$

In some cases, an annual index, rather than a specific inflation rate, is available. In such circumstances, an entity must perform the additional step of calculating the annual inflation rate for each year in the three-year period. The calculation of the cumulative inflation rate in such cases is illustrated in the table below.

**Calculation of Cumulative Three-Year Rate by Using an Index**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Base Year</th>
<th>X1</th>
<th>X2</th>
<th>X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index</td>
<td>100</td>
<td>125</td>
<td>175</td>
<td>225</td>
</tr>
<tr>
<td>Annual inflation rate</td>
<td>25.0% A</td>
<td>40.0% B</td>
<td>28.6% C</td>
<td></td>
</tr>
<tr>
<td>Cumulative rate</td>
<td>$\frac{(125 - 100)}{100}$</td>
<td>$\frac{(175 - 125)}{125}$</td>
<td>$\frac{(225 - 175)}{175}$</td>
<td>$\frac{(A+1) \times (B+1) \times (C+1) - 1}{1}$</td>
</tr>
</tbody>
</table>

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As noted in ASC 830-10-45-12, when the cumulative inflation rate is greater than 100 percent, the economy should be considered highly inflationary “in all instances.” When the cumulative rate is less than 100 percent, an entity must use judgment and carefully consider additional factors (e.g., trends). For example, when an economy’s cumulative three-year rate has increased each year and is approaching 100 percent, an entity should analyze whether this rate is expected to reach 100 percent in the near future. Similarly, as illustrated in the example in ASC 830-10-55-25, an entity would not automatically cease being considered highly inflationary simply because the cumulative inflation rate falls below 100 percent; rather, the entity should consider whether the decrease is temporary.

### 7.2.2 Role of the International Practices Task Force

Entities should consider the recent activities of the International Practices Task Force (IPTF) when determining whether an economy is highly inflationary. One of the IPTF’s activities is to monitor highly inflationary economies, and the Task Force’s meeting minutes (which are available on the Center for Audit Quality’s (CAQ’s) Web site) list those economies and identify which ones should be considered highly inflationary and which, while not currently considered highly inflationary, should be carefully monitored because of inflation trends.

As of November 2016, the IPTF had concluded that the following countries met the criteria to be considered highly inflationary:

- Malawi.
- South Sudan.
- Sudan.
- Ukraine.
- Venezuela.

The IPTF had also concluded as of November 2016 that entities should carefully monitor inflation trends for the following countries, which were previously considered to be highly inflationary or may become highly inflationary in the near future:

- Angola.
- Argentina.
- Islamic Republic of Iran.
- Suriname.

As previously mentioned, although ASC 830 does not specify which rates or indices should be used, those reported by the IMF are some of the most common ones employed.

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1. The IPTF is a task force of the SEC Regulations Committee that focuses on emerging international technical accounting and reporting issues related to SEC rules and regulations. According to the IPTF’s Web site, “[t]he objective of the IPTF is to protect investors by improving the quality of public company financial reporting by identifying, discussing, and facilitating resolution of issues relating to the promulgation, interpretation, and application of SEC rules, regulations, and policies with the assistance of the SEC staff and communicating those matters publicly on a timely basis.”

2. Note that the three-year cumulative inflation rate for Malawi was 91 percent in 2015 and was projected to be below 100 percent again in 2016. Nevertheless, the IPTF and SEC staff concluded that registrants should continue to treat the economy of Malawi as highly inflationary. The staff expects registrants to monitor Malawi's reported inflation data and consider other pertinent economic indicators to determine when it is appropriate to cease treating the economy as highly inflationary.

3. This list may not be all-inclusive; the IPTF obtains its data from the IMF, which does not obtain inflation data for all countries.

4. See Appendix B for additional discussion related to the IPTF’s decision on Argentina’s inflationary status.

5. Iran was previously considered highly inflationary; however, on the basis of inflation rates and discussions with the SEC staff, the IPTF determined that registrants should cease treating the economy of the Islamic Republic of Iran as highly inflationary no later than the first reporting period beginning on or after July 1, 2016.
Connecting the Dots

Inflation data is available on the IMF’s Web site. To access the data, an entity would perform the following steps:

1. On the home page, click the “Data” tab.
2. Select “World Economic Outlook [WEO] Databases.”
3. Select the appropriate database, depending on the period for which an index or rate is needed.
4. Select “By Countries (country-level data).”
5. Select either the applicable country group and specific countries of interest or “All countries,” then click “Continue.”
6. Under the “Monetary” header, select “Inflation, end of period consumer prices” (both the index and the percent change), then click “Continue.”
7. Select a date range (e.g., 2012–2016) and click “Prepare Report.”

The IMF WEO report estimates inflation in instances in which actual inflation data have not been obtained and describes the assumptions and methods used to develop those estimates. The WEO report is released semiannually, and the IMF data have limitations (e.g., the use of projected inflation data and inconsistent dates through which actual data are included in the table). Nevertheless, the calculated three-year cumulative inflation rates in the report are useful for determining which countries must be further analyzed.

The IMF’s Web site indicates that historical information may be updated in the future as more information becomes available. Further, the information may differ from that reported by the respective countries’ central banks or governments (e.g., because a country has not reported inflation data to the IMF in a timely fashion). Accordingly, entities using the IMF data should consider whether they need to supplement such data with other pertinent information.

If an entity determines that such additional information is necessary, management may need to consider the applicable country’s central bank or government Web site to obtain annual or month-end inflationary information. When the presentation of such information differs from that used by the IMF to report the inflation data, the data may need to be converted because of differences in presentation (e.g., certain countries have recently reset their base index to 100).

Although the IMF rates are some of the most commonly used rates, an entity’s management may consider other sources of information. In fact, while the IPTF uses the IMF data to present inflationary data in its meeting minutes, the IPTF acknowledges that the Task Force does “not [perform] procedures to identify any potential differences” between the data used by the Task Force and “the inflation data reported by the respective countries’ central banks or governments.” The IPTF therefore suggests that the “summarized IMF information [be] supplemented, to the extent considered necessary, with other pertinent information that may be available.” Regardless of the data used, however, management must consider both the source and reliability of the information.

Connecting the Dots

Note that management is responsible for monitoring inflation and determining that an economy is highly inflationary. The November 17, 2016, IPTF meeting highlights state, “Registrants are responsible for monitoring inflation in countries in which they have operations.” To the extent that management’s conclusion regarding an economy’s highly inflationary status is inconsistent with views expressed by the IPTF, consultation with accounting advisers is strongly encouraged.
7.3 Accounting Effects When an Economy Becomes Highly Inflationary

If the cumulative inflation calculation demonstrates that the entity has become highly inflationary, the entity should commence the requisite accounting on the first day of the next reporting period. In such scenarios, entities should consider whether disclosures are warranted in the reporting period before commencing highly inflationary accounting, as discussed further in Section 9.2.3.

**Example 7-2 — Designation as Highly Inflationary**

Company X is a calendar-year-end entity that has quarterly reporting requirements. In the first quarter, X determines that its local economy (whose currency is X's functional currency) has become highly inflationary on the basis of the inflationary data from the past 36 months. Company X therefore should begin applying the accounting for highly inflationary economies as of the beginning of the second quarter, or April 1. For first-quarter reporting purposes, X should continue to use the local currency as its functional currency but should disclose the adoption of highly inflationary accounting commencing in the next quarter.

As noted above, an entity with interim reporting requirements should not wait until the end of its fiscal year to record the effects of this designation. An entity that does not have interim reporting requirements should perform the cumulative-rate calculation as of its fiscal year-end and apply the effects of becoming highly inflationary to its financial statements at the beginning of the following year.

| Local Currency to the Reporting Currency as a Result of Economy Being Highly Inflationary |
|---------------------------------|---------------------------------------------------------------------------------|----------------|
| **Nonmonetary Assets and Liabilities** | **Monetary Assets and Liabilities** | **Effect on CTA** |
| Translated balances at the end of the prior period become the new accounting basis | Translated balances at the end of the prior period become the new accounting basis | No effect |

As summarized in the table above, when an economy is considered highly inflationary and an entity must remeasure its financial records in its parent's reporting currency, the accounting treatment is the same as that described in Chapter 2 for changes from the local currency to the reporting currency related to a significant change in facts and circumstances.

**Example 7-3 — Effects of a Change in Functional Currency to the Reporting Currency**

Company A, a public business entity, is a calendar-year-end entity that has operations in Country B such that B's local currency is A's functional currency. The functional currency of A's parent, which is also the reporting currency of the consolidated entity, is USD. During the first quarter of 20X1, B's economy is determined to be highly inflationary. In accordance with the guidance on highly inflationary economies in ASC 830, A reports its first-quarter results by using the local currency as its functional currency and translates its results into its parent's reporting currency (i.e., USD) for consolidation purposes. As of April 1, 20X1, the translated balances (i.e., the balances stated in the reporting currency) as of March 31, 20X1, become the new accounting bases for all monetary and nonmonetary assets and liabilities. Company A's equity accounts should be remeasured at the historical rates. Further, the CTA is not adjusted as a result of this change. Going forward, A will use the historical exchange rate on March 31, 20X1, when remeasuring A's nonmonetary assets and liabilities.
Because a change in functional currency due to an economy’s designation as highly inflationary results from changes in economic factors (i.e., inflation), such a change is not considered a change in accounting policy and therefore should not be accounted for as a change in accounting principle in accordance with ASC 250. Therefore, previously issued financial statements should not be restated. An entity’s management should, however, consider whether the change will have a material impact on future operations and, if so, disclose the change in the notes to its financial statements.

When an entity operates in a multitiered organization, the entity generally should use the reporting currency of its most immediate parent and not that of the ultimate parent, provided that the entity’s immediate parent does not operate in a highly inflationary economy. (However, this topic is not addressed in ASC 830.)

**Connecting the Dots**

If an entity believes that its facts and circumstances are such that it should use the reporting currency of an entity other than its immediate parent when becoming highly inflationary, the entity is encouraged to consult with its accounting advisers.

**Example 7-4 — Identification of an Entity’s Parent**

Company E is a third-tier entity within Company A’s multitiered international organization. Company A is headquartered in the United States, and its reporting currency is the USD; however, A globally has subsidiaries with multiple functional currencies. Company E has operations in Venezuela and is a direct subsidiary of Company B, which has operations in Mexico and a functional currency of MXN. Company A has determined that E’s functional currency is the BsF. At period-end, E’s financial statements are consolidated into B’s financial statements (i.e., translated into MXN), before being translated into A’s ultimate reporting currency (the USD).

As of December 31, 20X1, Venezuela’s economy is determined to be highly inflationary. As of January 1, 20X2, therefore, E’s financial statements should be remeasured into MXN (i.e., B’s functional currency), which will become its new functional currency. This is the case even though the USD is the ultimate reporting currency of the consolidated entity.
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7.3.1 Effects of Remeasuring Financial Statements

When an entity must remeasure its financial statements because an economy becomes highly inflationary, the entity must consider several implications in conjunction with the remeasurement. For example, an entity generally will continue to maintain its books and records in the local currency. In these cases, remeasurement in the “new” functional currency (i.e., the reporting currency of its immediate parent) is required in each reporting period. Monetary assets and liabilities should be remeasured by using current rates. However, nonmonetary assets and liabilities (including related income statement items such as depreciation), should be remeasured by using the exchange rate that was in effect on the date on which the entity began implementing the accounting related to highly inflationary economies. In addition, transaction gains and losses recognized in the local currency will need to be adjusted upon remeasurement if they are related to monetary items denominated in currencies other than the local currency.

See Chapter 4 for an example illustrating the application of these remeasurement requirements in situations in which the foreign currency is not the functional currency.

Income Taxes

ASC 830-10

Effect on Deferred Tax Benefits if Functional Currency Changes from Foreign Currency to Reporting Currency Because Foreign Economy Becomes Highly Inflationary

45-16 When the functional currency is the reporting currency, paragraph 740-10-25-3(f) prohibits recognition of deferred tax benefits that result from indexing for tax purposes assets and liabilities that are remeasured into the reporting currency using historical exchange rates. Thus, deferred tax benefits attributable to any such indexing that occurs after the change in functional currency to the reporting currency shall be recognized when realized on the tax return and not before. Deferred tax benefits that were recognized for indexing before the change in functional currency to the reporting currency are eliminated when the related indexed amounts shall be realized as deductions for tax purposes.

For more information about tax-related considerations related to foreign currency accounting, see Section 8.2.

Monetary Assets and Liabilities Denominated in Multiple Currencies

Another implication that entities should consider is the effect of a change in functional currency on monetary assets and liabilities that are denominated in multiple currencies.

Example 7-5 — Effects of Multiple Currencies on Monetary Items

If Company E from Example 7-4 above has trade payables that are denominated in MXN, it would not need to remeasure those payables; rather, their actual value in MXN should become their accounting basis when E’s functional currency changes to the MXN because Venezuela becomes highly inflationary.

If E has trade payables dominated in CAD, those payables would be translated directly from CAD to MXN (i.e., there would be no remeasurement in the BsF before consolidation into the Mexican parent).
Chapter 7 — Highly Inflationary Economies

Assets and Liabilities Subject to Multiple Exchange Rates

SEC Considerations
The SEC guidance below, which was codified in ASC 830-30-S99-1, pertains to an entity whose assets and liabilities are subject to multiple exchange rates, specifically those denominated in USD that have historically been translated at rates that caused the reported balances in USD to differ from the actual USD value. Note that Venezuela's 2010 designation as “highly inflationary” was used as a basis for writing the guidance.

ASC 830-30 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates
S99-1 This SEC staff announcement provides the SEC staff's views on Foreign Currency Issues.

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

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

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

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

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

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

Second, assume that at a period end prior to January 1, 2010 (for a calendar year entity), a U.S. entity's Venezuelan subsidiary held $15 million of accounts payable denominated in U.S. dollars (also assume the exchange rates are the same as in the example above). Upon the remeasurement of the U.S. denominated accounts payables to Bolivars and the subsequent translation of the Venezuelan subsidiary's financial statements, an entity would have reported accounts payable of $37.5 million for financial reporting purposes. (The $37.5 million is calculated as follows: First, the $15 million of accounts payable is remeasured using the parallel rate to 75 million BsF; subsequently, the 75 million BsF is translated back to U.S. dollars using the official rate of 2 Bolivars to 1 U.S. dollars, resulting in a translated reported balance of $37.5 million.)
Finally, the staff has noted that Venezuela has met the thresholds for being considered highly inflationary and accordingly, calendar year entities that have not previously accounted for their Venezuelan investment as highly inflationary will begin applying highly inflationary accounting beginning January 1, 2010.

**Disclosures**

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

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

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

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

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

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

**Other**

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

When “differences that may have existed prior to applying highly inflationary accounting requirements between the reported balances for financial reporting and the U.S. dollar denominated balances” are to be recognized in earnings, an entity should disclose the effects of the adjustment on the financial statements in the period before the entity reflects the accounting effects of the economy's becoming highly inflationary.
Connecting the Dots

Although the guidance above indicates that recognition of a CTA is a potential outcome of such circumstances, such an outcome is expected to be rare in practice. In cases in which an entity believes that it can demonstrate that the difference was previously recognized as a CTA, consultation with accounting advisers is strongly encouraged.

7.3.2 Deconsolidation Considerations

ASC 810-10-15-10(a)(1)(iii) states:

A majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner — for instance, 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.

Furthermore, ASC 830-20-30-2 states, in part:

If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the reporting entity shall be carefully considered.

In determining whether foreign exchange restrictions, controls, and other governmentally imposed uncertainties are severe enough to result in a lack of control by a parent entity, a reporting entity must use significant judgment. As a result of discussions with the SEC staff, we are aware that the staff did not object to a registrant’s conclusion to deconsolidate its Venezuelan operations as of December 2014 given, among other things, the country’s highly inflationary status (see further discussion regarding Venezuela in Appendix B). We understand that the two primary arguments cited by the registrant were (1) an other-than-temporary lack of currency exchangeability and (2) the existence of several government limitations on the registrant’s ability to control its Venezuelan operations. Examples of government intervention might include restrictions on (1) labor force reductions, (2) decisions about product mix or pricing, and (3) sourcing of raw materials or other inputs into the production process.

A reporting entity must use significant judgment in determining whether, given the specific facts and circumstances, the nonconsolidation of a majority-owned foreign subsidiary is appropriate. In making this determination with respect to operations in a foreign jurisdiction, the reporting entity should consider factors that include, but may not be limited to, the following:

- Volume restrictions on currency exchange activity (either explicit or in-substance), in conjunction with uncertainties about the reporting entity’s or subsidiary’s ability to obtain approval for foreign currency exchange through the established exchange mechanisms.
- The ability, currently and historically, to access available legal currency exchange mechanisms in volumes desired or needed by the reporting entity or subsidiary.
- Recent economic developments and trends in the foreign jurisdiction that might affect expectations about the future direction of restrictions on currency exchanges. For example, with respect to Venezuelan subsidiaries, recent developments related to the downward trend in the price of oil might affect expectations about the future direction of restrictions on currency exchange in Venezuela (i.e., the trend could adversely affect the Venezuelan government’s supply of U.S. dollars and thus further limit the amount of currency available through the established currency exchange mechanisms).
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• The extent and severity of restrictions imposed by the government on a subsidiary’s operations and whether those restrictions demonstrate the reporting entity’s inability to control its subsidiary’s operations. The reporting entity must use considerable judgment in making this determination since many governments, including the U.S. federal government, require companies to adhere to a framework of laws and regulations that govern operational matters.

The mere fact that currency exchangeability is lacking or that government controls exist may not in and of itself create a presumption that a reporting entity should not consolidate its foreign subsidiary, nor does the ability to exchange some volume of currency create a presumption that a reporting entity should consolidate its foreign subsidiary. However, the existence of the above factors represents negative evidence that a reporting entity should consider in determining whether consolidation is appropriate on the basis of the reporting entity’s specific facts and circumstances. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Chris Semesky, stated the following:

In the past year, OCA has observed registrant disclosures indicating a loss of control of subsidiaries domiciled in Venezuela. Disclosures indicate that these conclusions have been premised on judgments about lack of exchangeability being other than temporary and, also in some instances, the severity of government imposed controls. The application of U.S. GAAP in this area requires reasonable judgment to determine when foreign exchange restrictions or government imposed controls or uncertainties are so severe that a majority owner no longer controls a subsidiary. In the same way, a restoration of exchangeability or loosening of government imposed controls may result in the restoration of control and consolidation. In other words, I would expect consistency in a particular registrant’s judgments around whether it has lost control or regained control of a subsidiary. In addition, I would expect registrants in these situations to have internal controls over financial reporting that include continuous reassessment of foreign exchange restrictions and the severity of government imposed controls.

Further, to the extent a majority owner concludes that it no longer has a controlling financial interest in a subsidiary as a result of foreign exchange restrictions and/or government imposed controls, careful consideration should be given to whether that subsidiary would be considered a variable interest entity upon deconsolidation because power may no longer reside with the equity-at-risk holders. As a result, registrants should not only think about clear and appropriate disclosure of the judgments around, and the financial reporting impact of, deconsolidation but also of the ongoing disclosures for variable interest entities that are not consolidated.

If a reporting entity ultimately concludes that nonconsolidation of a foreign subsidiary is appropriate, the reporting entity must determine the appropriate date for any deconsolidation, including the appropriate currency exchange rate to use for remeasuring its deconsolidated investment and any other outstanding monetary balances that are no longer eliminated in consolidation (if they are not considered fully impaired). Furthermore, a reporting entity should clearly disclose the basis for its consolidation/nonconsolidation conclusion about an investment in a foreign subsidiary for which there is negative evidence regarding whether it controls the foreign subsidiary. A reporting entity that continues to consolidate may wish to consider disclosing its intention to continue monitoring developments, along with a description of the possible financial statement impact, if estimable, if deconsolidation were to occur. In addition, if a reporting entity concludes that nonconsolidation of a foreign subsidiary is appropriate, the reporting entity should continue to monitor developments in each reporting period to determine whether it has regained control and thus should reconsolidate the foreign subsidiary.

For more information about deconsolidation implications related to an economy’s designation as highly inflationary, see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*. For insights specific to Venezuela, see Appendix B.
7.4 Accounting Effects When an Economy Ceases to Be Highly Inflationary

**ASC 830-10**

Functional Currency Changes from Reporting Currency to Foreign Currency Because Foreign Economy Is No Longer Highly Inflationary

**45-15** If an entity's subsidiary's functional currency changes from the reporting currency to the local currency because the economy ceases to be considered highly inflationary, the entity shall restate the functional currency accounting bases of nonmonetary assets and liabilities at the date of change as follows:

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

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

**Example 1: Functional Currency Changes from Reporting Currency to Foreign Currency Because Foreign Economy Is No Longer Highly Inflationary**

**55-12** This Example illustrates the application of paragraph 830-10-45-15.

**55-13** A foreign subsidiary of a U.S. entity operating in a highly inflationary economy purchased equipment with a 10-year useful life for 100,000 local currency (LC) on January 1, 19X1. The exchange rate on the purchase date was LC 10 to USD 1, so the U.S. dollar equivalent cost was USD 10,000. On December 31, 19X5, the equipment has a net book value on the subsidiary's local books of LC 50,000 (original cost of LC 100,000 less accumulated depreciation of LC 50,000) and the current exchange rate is LC 75 to the U.S. dollar. In the U.S. parent's financial statements, annual depreciation expense of USD 1,000 has been reported for each of the past 5 years, and at December 31, 19X5, the equipment is reported at USD 5,000 (foreign currency basis measured at the historical exchange rate).

**55-14** As of the beginning of 19X6, the economy of the subsidiary ceases to be considered highly inflationary. Under paragraph 830-10-45-15, a new functional currency accounting basis for the equipment would be established as of January 1, 19X6, by translating the reporting currency amount of USD 5,000 into the functional currency at the current exchange rate of LC 75 to the U.S. dollar. The new functional currency accounting basis at the date of change would be LC 375,000. For U.S. reporting purposes, pursuant to this Subtopic, the new functional currency accounting basis and related depreciation would subsequently be translated into U.S. dollars at current and average exchange rates, respectively.

When an economy ceases to be designated as highly inflationary, an entity should discontinue using its parent's reporting currency as its functional currency, provided that the entity's facts and circumstances (as described in Chapter 2) have not changed in such a way that its functional currency should now be the same as the reporting currency used for highly inflationary accounting (e.g., analysis of the economic indicators described in ASC 830-10 results in the determination that the entity's functional currency should be that of its parent regardless of the inflationary status of its local economy). When the economy ceases to be highly inflationary, the nonmonetary assets and liabilities are converted at the exchange rate in effect on the date of change. (This treatment is different from that for changes in the functional currency that are not inflation-related.)

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When an entity changes its functional currency from the reporting currency to a foreign currency for reasons other than an economy's ceasing to be highly inflationary, nonmonetary assets and liabilities are converted in a manner that results in a difference between the historical reporting-currency basis and the new reporting-currency basis. As a result, the account balances would be reflected in the reporting currency as if the new functional currency had always been the functional currency; these differences would be recorded in a CTA. See Chapter 2 for additional details.
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The table below summarizes the effects of the change in these specific circumstances.

<table>
<thead>
<tr>
<th>Reporting Currency to Local Currency as a Result of Economy Ceasing to Be Highly Inflationary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonmonetary Assets and Liabilities</td>
</tr>
<tr>
<td>Remeasure by using exchange rate as of the date of change. Remeasured balance becomes the new basis.</td>
</tr>
</tbody>
</table>

Subsequent translations to reporting currency (e.g., at future period-ends) are performed using current exchange rates, with effects of exchange rate fluctuations recorded in CTA.

As when an entity changes its functional currency because an economy becomes highly inflationary, when an entity changes its functional currency because an economy is no longer highly inflationary, the change is not considered a change in accounting principle in accordance with ASC 250. Therefore, in such circumstances, previously issued financial statements should not be restated. An entity’s management should, however, consider whether the change will have a material impact on future operations and, if so, disclose the change in the notes to its financial statements.

Example 7-6 — Accounting for a Change in Functional Currency When an Economy No Longer Is Highly Inflationary

This example addresses the accounting records of Company X, a foreign entity operating in a highly inflationary economy whose parent company’s reporting currency is the USD. Because X’s local economy is deemed highly inflationary, it has been using the USD as its functional currency for a number of years. During the fourth quarter of 20X5, X’s local economy ceased being considered highly inflationary; therefore, X’s functional currency has changed from the USD (its reporting currency) back to its local currency (LC). The change was accounted for on January 1, 20X6. Assume the following:

1. Company X purchased all of its PP&E for 100,000 LC on December 31, 20X0, when the LC-to-USD exchange rate was 5:1. The PP&E has a 10-year life, and depreciation is calculated on a straight-line basis.
2. Company X’s local economy became highly inflationary in the fourth quarter of 20X2; therefore, X changed its functional currency to the USD on January 1, 20X3, when the LC-to-USD exchange rate was 15:1.

<table>
<thead>
<tr>
<th>Asset/Liability</th>
<th>LC Balance on 12/31/X2</th>
<th>Translated Balance on 1/1/X3 (Becomes New Basis)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>60,000 LC</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>PP&amp;E (net)</td>
<td>80,000 LC</td>
<td>$ 5,333</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>75,000 LC</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Total equity</td>
<td>65,000 LC</td>
<td>$ 4,333</td>
</tr>
</tbody>
</table>
Example 7-6 — Accounting for a Change in Functional Currency When an Economy No Longer Is Highly Inflationary (continued)

3. The LC-to-USD exchange rate on the date on which the local economy ceased being highly inflationary (i.e., January 1, 20X6) was 10:1.

<table>
<thead>
<tr>
<th>Asset/Liability</th>
<th>LC Balance on 12/31/X5</th>
<th>Remeasurement Before Change in January 20X6</th>
<th>Remeasurement in Local Currency in January 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>180,000 LC</td>
<td>$ 18,000</td>
<td>180,000 LC</td>
</tr>
<tr>
<td>PP&amp;E (net)</td>
<td>50,000 LC</td>
<td>$ 3,333</td>
<td>33,330 LC</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>135,000 LC</td>
<td>$ 13,500</td>
<td>135,000 LC</td>
</tr>
<tr>
<td>Total equity</td>
<td>95,000 LC</td>
<td>$ 7,833</td>
<td>78,330 LC</td>
</tr>
</tbody>
</table>

If it is assumed that the PP&E was purchased for 100,000 LC on December 31, 20X0, when the LC-to-USD exchange rate was 5:1, and that its useful life is 10 years (depreciation is calculated on a straight-line basis), the nonmonetary asset basis would have been 50,000 LC on January 1, 20X6, if the functional currency never changed to USD. However, as shown above, there is a 16,670 decrease in the LC basis because the functional currency changed as a result of the economy’s ceasing to be highly inflationary. While ASC 830 does not provide guidance on how to recognize this adjustment in the local books, we believe that an acceptable approach is to recognize the adjustment to opening retained earnings on the date of the change in functional currency.

Alternative Fact Pattern

Assume the same facts as above except that Company X is changing its functional currency from the USD (its reporting currency) to its local currency (LC) because of a significant change in economic facts and circumstances rather than because its local economy ceases to be highly inflationary. As explained in Chapter 2, when such a change is made, the reporting-currency accounting basis for nonmonetary assets and liabilities, such as the PP&E in this example, is adjusted for the difference between the exchange rates when the asset or liability arose and those when the entity’s functional currency changes. The change was accounted for in January 20X6. Assume the following:

1. Company X purchased all of its PP&E for 100,000 LC on December 31, 20X0, when the LC-to-USD exchange rate was 5:1. The PP&E has a 10-year life, and depreciation is calculated on a straight-line basis.
2. The LC-to-USD exchange rate on the date on which the change in functional currency was accounted for was 10:1.

<table>
<thead>
<tr>
<th>Asset/Liability</th>
<th>LC Balance on 12/31/X5</th>
<th>Remeasurement Before Change in January 20X6</th>
<th>Translation Into USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>180,000 LC</td>
<td>$ 18,000</td>
<td>$ 18,000</td>
</tr>
<tr>
<td>PP&amp;E (net)</td>
<td>50,000 LC</td>
<td>$ 10,000</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>135,000 LC</td>
<td>$ 13,500</td>
<td>$ 13,500</td>
</tr>
<tr>
<td>Total equity</td>
<td>95,000 LC</td>
<td>$ 14,500</td>
<td>$ 9,500</td>
</tr>
</tbody>
</table>

In this case, the local-currency basis of the nonmonetary asset does not change as a result of the change in functional currency. (This scenario is different from that above, in which the LC basis is adjusted because of the change associated with the economy’s ceasing to be highly inflationary.) Rather, the USD-denominated bases (i.e., the reporting-currency accounting bases) change, resulting in a decrease of $5,000 in the amount of PP&E. As explained in Chapter 2, this decrease due to the difference between the carrying value of the PP&E in the reporting currency (i.e., USD) at the historical exchange rate and that at the current exchange rate is recorded as a CTA.
In a manner consistent with a change in functional currency due to an economy’s becoming highly inflationary, an entity should be aware of several implications related to an economy’s ceasing to be highly inflationary. One of the most significant effects is that on deferred taxes, which is discussed in Chapter 9.

As explained in Chapter 2, a change in functional currency may have a number of other effects on an entity, a few examples of which are depicted in Section 2.4.2. An entity should carefully consider the impact of the change in functional currency on all of its account balances. For example, the lower-of-cost-or-market analysis required by ASC 330-10 would have to be performed in the new functional currency. In addition, an entity should revisit its various investing and hedging positions to determine whether changes in methods or strategies are warranted. Changes in functional currency may also affect the local subledgers the entity maintains in its local currency (such as the adjustment to retained earnings described above).

Further, for consolidated entities that determined deconsolidation was necessary for a subsidiary in a highly inflationary economy, such conclusions should be revisited. Deconsolidation is discussed further in Appendix C.
Chapter 8 — Income Taxes

8.1 Chapter Overview
ASC 740 provides guidance on accounting for income taxes and applies to all entities (both domestic and foreign) within a reporting entity. The two primary objectives of ASC 740 are to (1) “recognize the amount of taxes payable or refundable for the current year” and (2) “recognize deferred tax liabilities [DTLs] and assets [DTAs] for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns.”

With respect to the second objective, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position (i.e., its book basis), referred to as a temporary difference, will generally result in the recognition of either a DTA or a DTL. DTAs are recorded for temporary differences and carryforwards that will result in a decrease to taxes payable in future years (sometimes referred to as tax benefits). DTLs, on the other hand, are recorded for temporary differences that will result in an increase to taxes payable in future years. See Deloitte’s A Roadmap to Accounting for Income Taxes for further guidance on accounting for DTAs and DTLs under ASC 740.

However, while ASC 740 addresses the income tax accounting for most potential temporary differences, ASC 830-740 includes additional guidance on specific types of temporary differences that may arise for entities operating in a foreign country.

### ASC 830-740

**05-2** This Subtopic addresses the accounting for specific types of basis differences for entities operating in foreign countries. The accounting addressed in this Subtopic is limited to the deferred tax accounting for changes in tax or financial reporting bases due to their restatement under the requirements of tax laws or generally accepted accounting principles (GAAP) in the United States. These changes arise from tax or financial reporting basis changes caused by any of the following:

- a. Changes in an entity’s functional currency
- b. Price-level related changes
- c. A foreign entity’s functional currency being different from its local currency.

This Subtopic addresses whether these changes, which can affect the amount of basis differences, result in recognition of changes to deferred tax assets or liabilities.

Each of the specific types of basis differences identified in the paragraph above is discussed in further detail in the remaining sections of this chapter.

8.2 Functional Currency Is Different From the Local Currency
As discussed in Chapter 2, an entity’s functional currency is determined by considering each of the economic factors in ASC 830-10-55. After considering these factors, management may determine that an entity’s functional currency is the currency of the jurisdiction in which the entity operates (i.e., the local currency) or some other currency (e.g., the reporting currency of its parent).
Further, as discussed in Chapter 4, each balance sheet and income statement account must be measured in an entity’s functional currency for financial reporting purposes. Therefore, if a balance sheet or income statement account is denominated in a currency other than the functional currency (i.e., a foreign currency), it must be remeasured from the foreign currency to the functional currency. In addition, if an entity’s books and records are not maintained in the functional currency, the entity must remeasure each balance sheet and income statement account in the functional currency. Therefore, an entity’s book basis in an asset or liability is also established in its functional currency.

However, regardless of an entity’s functional currency for financial reporting purposes, its tax return is generally prepared in the local currency. Therefore, an entity’s tax basis in an asset or liability is also typically established in the local currency.

Therefore, the book basis of an asset or liability is determined in the entity’s functional currency while the tax basis of that asset or liability is generally determined in the local currency of the jurisdiction in which the entity operates. Because the tax return is generally prepared in the local currency (and taxable income therefore is determined in the local currency), an entity must also calculate temporary differences in the local currency to determine the amount that will ultimately result in an increase or decrease to taxes payable in future years.

A fundamental assumption in ASC 740 regarding the accounting for temporary differences is that assets will be recovered and liabilities will be settled at their respective book basis, which is determined in the entity’s functional currency. Therefore, if the functional currency is different from the local currency, changes in the exchange rate will also change the amount of local currency revenues necessary to recover or settle the book basis of an asset or liability; however, the local currency tax basis will not change. In addition, because temporary differences (i.e., the difference between the book basis and tax basis) must be determined in the local currency, fluctuations in exchanges will affect the book basis of an asset or liability when calculated in the local currency. The following example illustrates this concept:

---

**Example 8-1 — Basis Differences Caused by Changes in Exchange Rates**

Entity S is a foreign subsidiary of Entity P. The functional currency of S is the USD, which is not the LC of the jurisdiction in which S operates. Assume the following:

- On July 1, 20X1, S purchases a piece of inventory for 5,000 LC when the exchange rate is 1 USD to 1.25 LC.
- Entity S’s tax basis in the asset is 5,000 LC (the amount paid to acquire the asset).
- Entity S’s book basis in the asset is 4,000 USD (5,000 LC ÷ 1.25).
- The inventory is still on hand as of December 31, 20X1, when the exchange rate is 1 USD to 1.5 LC.

In this example, the amount of local currency revenues necessary to recover the functional-currency-book basis of the inventory has increased from 5,000 LC on July 1, 20X1, to 6,000 LC on December 31, 20X1, as a result of changes in the exchange rate. However, the entity’s tax basis in the inventory remains unchanged at 5,000 LC, as shown in the table below:

<table>
<thead>
<tr>
<th></th>
<th>7/1/20X1</th>
<th>12/31/X1</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functional currency book basis</td>
<td>4,000 USD</td>
<td>4,000 USD</td>
<td>—</td>
</tr>
<tr>
<td>Spot exchange rate</td>
<td>1.25</td>
<td>1.5</td>
<td>—</td>
</tr>
<tr>
<td>LC book basis</td>
<td>5,000 LC</td>
<td>6,000 LC</td>
<td>1,000 LC</td>
</tr>
<tr>
<td>LC tax basis</td>
<td>5,000 LC</td>
<td>5,000 LC</td>
<td>—</td>
</tr>
</tbody>
</table>
In the example above, the difference between the local currency book basis and the local currency tax basis of 1,000 LC on December 31, 20X1, technically meets the definition of a temporary difference under ASC 740. However, ASC 740 (ASC 830-740) contains special rules for the recognition of DTAs and DTLs related to temporary differences that are caused by changes in exchange rates.

**ASC 740-10**

25-3 The only exceptions in applying those basic requirements are: . . .

f. A prohibition on recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. See Subtopic 830-740 for guidance on foreign currency related income taxes matters.

**ASC 830-740**

25-10 As indicated in paragraph 740-10-25-3(f), recognition is prohibited for a deferred tax liability or asset for differences related to assets and liabilities that, under the requirements of Subtopic 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes.

In accordance with the guidance above, an entity is prohibited from recognizing deferred taxes for basis differences that are related to nonmonetary assets and liabilities and are caused by either (1) changes in exchange rates or (2) indexing for tax purposes. However, an entity is not prohibited from recognizing deferred taxes for basis differences that are related to monetary assets and liabilities denominated in the functional currency (see Section 8.2.2) and are caused by changes in exchange rates or indexing because those assets and liabilities are remeasured at current exchange rates (i.e., the prohibition only applies to assets and liabilities that are remeasured at historical exchange rates). Therefore, the proper determination of whether an asset or liability is monetary or nonmonetary (see Section 4.3.3) is critical to ensuring that the income taxes associated with that asset or liability are appropriately accounted for.

**Connecting the Dots**

The reason the prohibition applies only to nonmonetary assets and liabilities is because they are remeasured from the local currency to the functional currency by using historical exchange rates. Therefore, no transaction gains or losses are recognized in the financial statements as a result of remeasuring these assets or liabilities from the foreign currency to the functional currency. As a result, the FASB decided to prohibit recognition of the deferred tax consequences for this type of temporary difference because doing so would result in the recognition of deferred taxes related to transaction gains and losses that are not recognized in earnings under ASC 830.

Further, the prohibition in ASC 830-740-25-10 only applies to basis differences that result from changes in exchange rates or indexing. Therefore, if a basis difference exists for a nonmonetary asset or liability that is not caused by changes in exchange rates or indexing, an entity must record deferred taxes related to that basis difference. For example, a basis difference may exist for an item of PP&E (a nonmonetary asset) because of differences in how that asset is depreciated for book and tax purposes. In addition, this prohibition only applies when the functional currency is different from the local currency. Therefore, if the functional currency is the same as the local currency, an entity should recognize deferred taxes associated with basis differences that are caused by indexing for tax purposes.
Therefore, the recognition of deferred taxes for entities operating in a foreign country depends, as illustrated in the graphic below, on (1) whether the functional currency is different from or the same as the local currency; (2) whether the asset or liability is monetary or nonmonetary; and (3) the reason for the basis difference.

**Functional Currency Is the Local Currency**

**Do:** Recognize deferred taxes for local currency basis differences and indexing for tax purposes (if applicable).

**Do:** Recognize deferred taxes for all differences between book and tax bases (i.e., local currency basis differences and indexing for tax purposes).

**Don't:** Recognize deferred taxes for assets and liabilities denominated in the local currency caused by changes in exchange rates.

**Don't:** Recognize deferred taxes for differences caused by changes in exchange rates or indexing.

**Functional Currency Is Not the Local Currency**

**Do:** Recognize deferred taxes for basis differences caused by (1) local currency book/tax differences; (2) indexing for tax purposes (if applicable); and (3), if the asset or liability is denominated in the functional currency, changes in exchange rates.

**Do:** Recognize deferred taxes for differences between the local currency book and tax bases.

**Don't:** Recognize deferred taxes for differences caused by changes in exchange rates or indexing.

The income tax accounting for nonmonetary and monetary assets and liabilities is discussed in further detail in the sections below.

### 8.2.1 Nonmonetary Assets and Liabilities

As discussed in Chapter 4, when the functional currency is not the local currency, an entity is required to remeasure nonmonetary assets and liabilities (e.g., PP&E) from the local currency to the functional currency by using historical exchange rates. Because historical exchange rates are used in the remeasurement process, the prohibition in ASC 740-10-25-3(f), as discussed above, applies. Therefore, an entity would be precluded from recognizing deferred taxes for any portion of the difference between the book basis and tax basis that is caused by either changes in the exchange rate or indexing for tax purposes.

However, it is not uncommon for differences to exist between the book basis and the tax basis of a nonmonetary asset or liability as a result of differences between U.S. GAAP and the relevant tax laws in the local jurisdiction. For example, PP&E is often depreciated differently under U.S. GAAP than it is under the local tax laws, resulting in differences between the book basis and tax basis of that asset. Deferred taxes must be recognized for these types of basis differences, regardless of whether the functional currency is the same as or different from the local currency. However, when the functional currency is different from the local currency, the deferred taxes would first be determined in the local currency and
would then be remeasured in the functional currency at the current exchange rate as deferred taxes are considered monetary accounts (see Section 4.13). The following example illustrates the deferred tax accounting for nonmonetary assets or liabilities when the functional currency is different from the local currency:

**Example 8-2 — Basis Differences for Nonmonetary Assets and Liabilities Not Caused by Changes in Exchange Rates or Indexing**

Entity S is a foreign subsidiary of Entity P. The functional currency of S is the USD, which is not the LC of the jurisdiction in which S operates. Assume the following:

- On January 1, 20X1, S purchases a piece of equipment for 500,000 LC when the exchange rate is 1 USD to 1.25 LC.
- The equipment is depreciable on a straight-line basis over 10 and 5 years for financial reporting and tax purposes, respectively.
- The exchange rate on December 31, 20X1, is 1 USD to 1.5 LC.
- The weighted-average exchange rate during 20X1 is 1 USD to 1.35 LC.
- The tax rate in S’s jurisdiction is 30 percent.

The table below illustrates the calculation of S’s book and tax basis in the equipment on January 1, 20X1, and December 31, 20X1, respectively, in both the local currency and functional currency.

<table>
<thead>
<tr>
<th></th>
<th>Book Basis</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>LC</td>
<td>USD</td>
</tr>
<tr>
<td>1/1/20X1</td>
<td>500,000</td>
<td>400,000</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>450,000</td>
<td>360,000</td>
</tr>
</tbody>
</table>

In the example above, if the effects of the change in the exchange rate are ignored, a basis difference exists for the equipment because of the difference in how it is depreciated for book and tax purposes. Specifically, on December 31, 20X1, the book basis of the equipment in the local currency (i.e., before remeasurement in the functional currency) is 450,000 LC while the tax basis is 400,000 LC.

Entity S must record a DTL of 15,000 LC and a deferred tax expense related to this basis difference (50,000 LC basis difference × 30 percent tax rate) even though its functional currency is different from the local currency. The DTL must then be remeasured in the functional currency at the December 31, 20X1, spot rate while the deferred tax expense is remeasured at the weighted-average exchange rate in effect during 20X1. The difference between these two amounts results in a transaction gain during 20X1, as illustrated in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Local Currency</th>
<th>Ex. Rate</th>
<th>Functional Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning-of-year DTL at beginning-of-year rate</td>
<td>—</td>
<td>1.25</td>
<td>—</td>
</tr>
<tr>
<td>Beginning-of-year DTL at end-of-year rate</td>
<td>—</td>
<td>1.5</td>
<td>—</td>
</tr>
<tr>
<td>Transaction gain (loss)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>DTE at weighted-average rate</td>
<td>(15,000)</td>
<td>1.35</td>
<td>(11,111)</td>
</tr>
<tr>
<td>DTE at end-of-year rate</td>
<td>(15,000)</td>
<td>1.5</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Total foreign currency transaction gain (loss)</td>
<td></td>
<td></td>
<td>1,111*</td>
</tr>
</tbody>
</table>

* In accordance with ASC 830-740-45-1, S may present the transaction gain as a deferred tax benefit (as opposed to a transaction gain) if that presentation is considered more useful. If the transaction gain is reported in that manner, it would still be included in the aggregate transaction gain or loss for the period to be disclosed, as required by ASC 830-20-45-1.
Example 8-2 — Basis Differences for Nonmonetary Assets and Liabilities Not Caused by Changes in Exchange Rates or Indexing (continued)

In addition, if S were to sell the equipment on December 31, 20X1, its hypothetical local currency proceeds would be 540,000 LC (functional currency book basis of 360,000 USD × current exchange rate of 1.5). In other words, the amount of local currency revenue needed to recover the functional currency book basis of the equipment on December 31, 20X1, is 540,000 LC. Therefore, the total difference between the book basis of the equipment when converted to LC and the tax basis of the equipment is 140,000 LC on December 31, 20X1 (book basis of 540,000 LC minus tax basis of 400,000 LC). The incremental basis difference of 90,000 LC is caused by the change in the exchange rate from July 1, 20X1, to December 31, 20X1. Therefore, under ASC 740-10-25-3(f), S would not record a DTL associated with this portion of the basis difference.

In addition to fluctuations in the exchange rate, basis differences may arise for nonmonetary assets and liabilities as a result of indexing that is permitted or required under the local tax law. Specifically, certain countries (especially those that are considered highly inflationary) may permit the tax basis of assets to be indexed to take into account the effects of inflation. However, under ASC 740-10-25-3(f), when the functional currency is not the local currency, the recognition of a DTL or DTA is prohibited for differences related to indexing for tax purposes. However, if the foreign entity's local currency is the functional currency, the prohibition does not apply and the foreign entity would recognize the deferred tax effects of any indexing. Example 8-3 illustrates this concept.

Example 8-3 — Basis Differences for Nonmonetary Assets and Liabilities Caused by Indexing for Tax Purposes

Assume that X, an entity reporting under U.S. GAAP in USD, has operations in a foreign country where the local currency is the functional currency. At the beginning of 20X2, the foreign jurisdiction enacts tax legislation that increases the tax basis of depreciable assets by 10 percent. That increase will permit X to deduct additional depreciation in current and future years. Further assume that (1) X is subject to the guidance in ASC 740 and that, at the end of 20X1, the basis of depreciable assets is 1,000 LC for tax and financial reporting purposes; (2) the foreign tax rate is 50 percent; and (3) the current exchange rate is 1 USD to 2 LC.

Under ASC 740, X establishes a DTA on the enactment date. The DTA is measured in accordance with foreign tax law and is determined on the basis of the deductible temporary difference between the financial reporting basis of the asset (1,000 LC) and the indexed tax basis (1,100 LC). Thus, at the beginning of 20X2, X records a DTA of 50 LC [(1,100 – 1,000) × 50%] in the local currency books of record. That DTA is translated as $25 (50 FC × 0.5) on the basis of the current exchange rate.

8.2.2 Monetary Assets and Liabilities

When a foreign entity's functional currency is different from the local currency, the foreign entity's deferred tax accounting for monetary assets and liabilities depends on whether such assets or liabilities are denominated in the local currency or the functional currency.

8.2.2.1 Local-Currency-Denominated Monetary Assets and Liabilities

When a monetary asset or liability is denominated in an entity's local currency, it must be remeasured in the entity's functional currency as of each reporting date by using the current exchange rate for financial reporting purposes. Therefore, fluctuations in the exchange rate between the local currency and the functional currency will result in (1) changes in the financial reporting carrying value of the monetary asset or liability and (2) transaction gains and losses for financial reporting purposes.
However, although a pretax gain or loss is recognized for financial reporting purposes, exchange rate fluctuations will not result in taxable income or loss when the asset is recovered or the liability is settled, since the local currency is used to determine taxable income (i.e., those gains and losses only exist when the asset or liability is measured in the functional currency). Further, these exchange rate fluctuations do not contribute to any difference between the book and tax basis of the asset or liability when the book basis is measured in the local currency. Therefore, there are no current or deferred tax consequences related to the transaction gains and losses.

**Example 8-4 — Local-Currency-Denominated Debt**

Entity A, a foreign entity located in Canada, has a U.S. parent that uses the USD as its reporting currency. In accordance with ASC 830, A determines that its functional currency is the reporting currency of its parent (USD) and not the local currency, the CAD. On September 30, 20X5, A obtains a loan for CAD 100 million from its U.S. parent when the exchange rate is USD 1 to CAD 1.25. The exchange rate on December 31, 20X5, is USD 1 to CAD 1.33.

On September 30, 20X5, the date of the borrowing, A records the loan at its USD-equivalent value of USD 80 million (CAD 100 million ÷ 1.25). Entity A’s tax basis in the borrowing is the initial amount borrowed of CAD 100 million (i.e., the tax basis is the local-currency-denominated amount).

On December 31, 20X5, A remeasures the liability from its local-currency-denominated value of CAD 100 million to USD by using the exchange rate in effect on that date. The remeasured value of USD 75 million (CAD 100 million ÷ 1.33) results in an unrealized pretax transaction gain of USD 5 million for financial reporting purposes, which is the difference between the financial-statement carrying value (in USD) on September 30, 20X5, and that on December 31, 20X5.

However, on December 31, 20X5, there is no unrealized gain for tax purposes because there is no difference between the amount required to settle the liability (CAD 100 million) and the tax basis of the liability (CAD 100 million). Since taxable income is determined by using CAD and the loan is denominated in CAD, the balance is unchanged from its original tax basis of CAD 100 million and there is no unrealized gain for tax corresponding to the gain for financial reporting. Therefore, although the fluctuation in the exchange rate results in a pretax gain for financial reporting purposes, A would not record any deferred taxes.

**Connecting the Dots**

As discussed in Example 8-4, Entity A will have pretax gain or loss on a separate-company basis but will not have any corresponding tax expense or benefit. Likewise, its parent would also have an equal and offsetting pretax gain or loss related to the CAD-denominated loan (on a consolidated basis, there will be no net pretax gain or loss). While such a pretax gain or loss will not have any tax effects for A (since A’s tax return is filed in CAD), there will be a tax effect related to the U.S. parent’s pretax amount since the parent uses USD in filing its tax return. The U.S. parent will have a deferred tax effect related to the CAD-denominated loan since the USD amount required to settle the loan fluctuates from the tax basis of the liability (the USD equivalent of the CAD 100 million when the loan is entered into). In summary, there will be no pretax gain or loss on a consolidated basis and no Canadian tax effect for A; however, there will be a tax effect for the U.S. parent, which will affect the effective tax rate.

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1 In some jurisdictions, a foreign entity might be able to elect to use the functional currency to determine its taxable income. In other jurisdictions, use of the functional currency might be allowed by ruling. However, both of these exceptions are extremely rare; the local currency is almost always used to determine taxable income.
8.2.2.2 Functional-Currency-Denominated Monetary Assets and Liabilities

Unlike the local-currency-denominated monetary assets and liabilities discussed in Section 8.2.2.1 above, monetary assets or liabilities denominated in an entity's functional currency do not need to be remeasured for financial reporting purposes. Therefore, in such cases, currency fluctuations do not give rise to pretax transaction gains or losses for financial reporting purposes.

However, because ASC 740 assumes that assets will be recovered and liabilities will be settled at their respective financial reporting values (i.e., at book basis), changes in the exchange rate will change the amount of local currency revenues necessary to recover or settle the book basis of the asset or liability; however, the local currency tax basis will not change. Therefore, although no pretax gain or loss is recognized for financial reporting purposes, current or deferred taxes may be required depending on whether the entity will be taxed on a realized or unrealized basis:

- **Realized basis (or “settlement approach”)** — The transaction gain or loss is included in taxable income only on the date the asset is recovered or the liability is settled. The amount of gain or loss is calculated by comparing the initial tax basis of the asset or liability with its tax basis when the asset or liability is recovered or settled, respectively. The initial tax basis of the asset or liability is generally the local currency equivalent of the functional currency carrying value, determined by using the spot rate on the transaction date. The tax basis of the asset or liability upon settlement is generally the local currency equivalent of the functional currency carrying value, determined by using the spot rate on the settlement/recovery date.

- **Unrealized basis (or “mark-to-spot approach”)** — The unrealized transaction gain or loss is included in taxable income each year. The amount of unrealized gain or loss is calculated by comparing the initial tax basis of the asset or liability with its tax basis at the end of each year. The initial tax basis is determined in the same manner as the initial tax basis determined under the settlement approach described above. The tax basis of the asset or liability at the end of each year is generally the local currency equivalent of the functional currency carrying value, determined by using the spot rate in effect at the end of the year.

If a foreign entity is taxed under the settlement approach, it is necessary to calculate a temporary difference and related DTL or DTA as of the end of each reporting period. The amount of deferred taxes required is equal to the difference between the initial tax basis of the asset or liability (in local currency) and the local currency equivalent of the functional currency carrying value, determined by using the exchange rate in effect at the end of the year and multiplied by the enacted tax rate.

Conversely, for jurisdictions that tax unrealized transaction gains or losses under the mark-to-spot approach, there will generally be no temporary difference since the entire unrealized amount will be included in taxable income as it arises and a corresponding current tax expense or benefit will be recognized.

Because any tax expense or benefit (whether current or deferred) will not have a corresponding pretax book amount, the related tax expense or benefit will generally affect the effective tax rate that should be appropriately disclosed in the footnotes to the financial statements.
Example 8-5 — Reporting-Currency-Denominated Debt

Assume the same facts as in Example 8-4 except that the loan is denominated in USD and A’s tax rate is 30 percent.

On September 30, 20X5, the date of the borrowing, A records the loan at its USD-equivalent value of USD 100 million. Entity A’s initial tax basis in the loan is CAD 125 million, the local currency equivalent of the amount borrowed, which is calculated by using the exchange rate in effect on the date of the borrowing (USD 100 million × 1.25).

On December 31, 20X5, the financial reporting carrying value of the loan is still USD 100 million since the loan is denominated in the functional currency. However, the local-currency-equivalent value of the loan has changed to CAD 133 million as a result of the fluctuation in the exchange rate. Therefore, the change in the exchange rate has created an unrealized tax loss of CAD 8 million (equal to the difference between the book and tax basis of the loan when converted into the local currency).

If A is taxed under the settlement approach, it would record a DTA of CAD 2.4 million, which is equal to the tax effect of the difference between the tax basis of the loan and the local-currency-equivalent value on December 31, 20X5 ([CAD 125 million – CAD 133 million] × 30%). The DTA would be recognized at the average exchange rate (to determine the amount to recognize as an income tax benefit) and would then be remeasured at the exchange rate in effect on December 31, 20X5; any difference between the two amounts would be included in the income statement. Under ASC 830-740-45-1, A may present the transaction gain or loss that results from remeasuring the DTA as deferred tax expense or benefit (rather than as a transaction gain or loss) if such presentation is considered more useful. If reported in that manner, the transaction gain or loss would still be included in the aggregate transaction gain or loss for the period, which is disclosed in accordance with ASC 830-20-45-1.

Conversely, if A is taxed under the mark-to-spot approach, it would recognize a taxable loss of CAD 8 million and should record a CAD 2.4 million reduction in current tax payable and a CAD 2.4 million income tax benefit.

In Example 8-5, there will be no pretax income for either A or the U.S. parent, nor will there be such income in consolidation (since A, the U.S. parent, and the consolidated financial statements use USD). Further, the U.S. parent in this example (unlike the U.S. parent in Example 8-4) will have no tax effect since the loan is denominated in USD and the U.S. parent files its tax return in USD. However, A will have a tax effect (either current or deferred, depending on Canadian tax law) related to the loan, since it files its tax return in CAD but the loan is denominated in USD.

In summary, in both examples, there is no consolidated pretax gain or loss. (In Example 8-4, there are equal and offsetting pretax amounts; in Example 8-5, because the loan is denominated in USD, there is no pretax gain or loss in either A or the U.S. parent.) In each example, there is a tax effect in the consolidated financial statements (and that tax effect affects the effective tax rate, since there is a tax effect with no corresponding pretax amount). In Example 8-4, the loan is denominated in CAD so the tax effect is in the U.S. parent; in Example 8-5, the loan is denominated in USD so the tax effect is in A.

8.3 Changes in an Entity’s Functional Currency

As discussed in Chapter 2, an entity may determine that it needs to change its functional currency as a result of significant changes in economic facts and circumstances. For example, changes in functional currency may result from one-time transactions, such as a merger or acquisition, or from a longer-term shift in an entity’s operations. Regardless of the reason, it is important that management carefully consider whether such an event is significant enough to warrant a change in the functional currency.

In addition, as discussed in Chapter 7, when the country in which a foreign entity operates becomes highly inflationary, the entity must change its functional currency to its immediate parent’s reporting currency (e.g., the USD). Likewise, when the country in which a foreign entity operates ceases to be highly inflationary, the entity should discontinue using its immediate parent’s reporting currency as
Chapter 8 — Income Taxes

its functional currency, provided that the entity's facts and circumstances (as described in Chapter 2) have not changed in such a way that its functional currency should now be the same as the reporting currency used for highly inflationary accounting (e.g., analysis of the economic indicators described in ASC 830-10 results in the determination that the entity's functional currency should be that of its parent regardless of the inflationary status of its local economy).

Regardless of the reason, ASC 830 requires entities to account for the effects of a change in the functional currency by remeasuring the carrying value of its assets and liabilities into the new functional currency. ASC 830-740 addresses the accounting for the income tax effects related to a change in the functional currency, which differs depending on whether the functional currency changed to or from the reporting currency, as described in further detail below.

### 8.3.1 Changes From the Local Currency to a Different Currency

<table>
<thead>
<tr>
<th><strong>ASC 830-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-10</strong> If the functional currency changes from a foreign currency to the reporting currency, translation adjustments for prior periods shall not be removed from equity and the translated amounts for nonmonetary assets at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods. This guidance shall be used also to account for a change in functional currency from the foreign currency to the reporting currency when an economy becomes highly inflationary.</td>
</tr>
</tbody>
</table>

In accordance with the guidance above, because the pretax carrying amounts of the entity's assets and liabilities do not change when the functional currency changes to the reporting currency, temporary differences also do not change. Therefore, the entity's DTAs and DTLs should not be adjusted on the date the functional currency changes.

However, because the local currency is no longer the functional currency, the guidance in ASC 740-10-25-3(f) would be applied prospectively from the date of the change. Therefore, after the functional currency is changed to the reporting currency, an entity would be prohibited from recognizing DTAs or DTLs for temporary differences related to nonmonetary assets and liabilities that are caused by changes in the exchange rate or indexing for tax purposes. See Section 8.2.1 for more information about accounting for temporary differences related to nonmonetary assets and liabilities that are caused by changes in the exchange rate or indexing for tax purposes. Nevertheless, an entity would continue to recognize deferred taxes for (1) differences related to the effects of exchange rate changes associated with functional-currency-denominated monetary assets and liabilities (see Section 8.2.2) and (2) other differences (excluding the effects of indexing, which are discussed below) between the local currency book basis and local currency tax basis of nonmonetary assets (e.g., differences arising when a nonmonetary asset is depreciated over different periods for book and tax purposes).

<table>
<thead>
<tr>
<th><strong>ASC 830-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-16</strong> When the functional currency is the reporting currency, paragraph 740-10-25-3(f) prohibits recognition of deferred tax benefits that result from indexing for tax purposes assets and liabilities that are remeasured into the reporting currency using historical exchange rates. Thus, deferred tax benefits attributable to any such indexing that occurs after the change in functional currency to the reporting currency shall be recognized when realized on the tax return and not before. Deferred tax benefits that were recognized for indexing before the change in functional currency to the reporting currency are eliminated when the related indexed amounts shall be realized as deductions for tax purposes.</td>
</tr>
</tbody>
</table>
In accordance with the guidance above, deferred tax effects (either a lesser DTL or a DTA) that were recognized as a result of indexing before the change in functional currency to the reporting currency are not derecognized on the date the functional currency changes (i.e., previously recognized DTAs should not be reversed when the functional currency is changed to the reporting currency). Rather, such effects reverse over time as those benefits are realized on the tax return. Going forward, no new DTAs should be recognized for the effects of indexing that occur after the change in the functional currency.\(^2\)

**Connecting the Dots**

Because the effects of indexing are ignored for deferred tax accounting purposes when the functional currency is different from the local currency, the current-year tax depreciation of indexation not recognized under ASC 740 (i.e., any indexation that occurs after the functional currency changes to the reporting currency) will result in a favorable permanent difference. Therefore, the excess tax depreciation (due to unrecognized indexing) will result in a lower effective tax rate in the year in which it is realized on an entity’s tax return. Accordingly, the prohibition in ASC 740-10-25-3(f) causes the timing of recognizing the indexing-related tax benefit to shift from the period in which the indexing occurs to the period in which the additional tax basis is depreciated or amortized (even when the resulting deduction increases a net operating loss carryforward).

**Example 8-6 — Change in the Functional Currency From the Local Currency to the Reporting Currency**

Entity A, a foreign entity, uses the LC as its functional currency. Entity A’s parent is a U.S. entity that uses the USD as its reporting currency. On January 1, 20X5, A acquires a piece of equipment for 1 million LC. The equipment is depreciated on a straight-line basis over four years for both book and tax purposes. The tax laws of the foreign country in which A operates allow for a 15 percent increase in the tax basis at the end of each year (i.e., the depreciable tax basis includes the additional tax basis from indexation). Assume that A’s tax rate is 40 percent.

Entity A’s deferred taxes on the temporary difference associated with the equipment are calculated as follows (all amounts are in LC):

<table>
<thead>
<tr>
<th>Tax Basis</th>
<th>Book Basis</th>
<th>Temporary Difference</th>
<th>DTA/(DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis on January 1, 20X5</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>20X5 depreciation expense</td>
<td>250,000</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>750,000</td>
<td>750,000</td>
<td></td>
</tr>
<tr>
<td>20X5 indexing</td>
<td>112,500</td>
<td>—</td>
<td>112,500</td>
</tr>
<tr>
<td>Basis on December 31, 20X5</td>
<td>862,500</td>
<td>750,000</td>
<td>112,500</td>
</tr>
</tbody>
</table>

On December 31, 20X5, A would recognize a DTA of 45,000 LC (temporary difference of 112,500 LC × 40% tax rate). Because the local currency is A’s functional currency, A measures the DTA as the difference between the book basis and the tax basis after taking into account the effects of indexing. In the example above, the DTA recognized is solely related to the increase in the tax basis of the equipment that resulted from indexing in 20X5 (i.e., there is no difference between the local currency book and tax basis of the equipment, excluding the effects of indexing). The DTA would be recognized at the average exchange rate (to determine the amount to recognize as an income tax benefit) and would then be retranslated at the exchange rate in effect on December 31, 20X5; any difference between the two amounts would be included in CTA.

\(^2\) Because the exception only applies to deferred tax accounting, the current tax benefit related to the depreciation or amortization of the tax basis from indexation should be recognized.
Example 8-6 — Change in the Functional Currency From the Local Currency to the Reporting Currency (continued)

Assume that on January 1, 20X6, the country in which A operates becomes highly inflationary (or that A otherwise determines that its functional currency has changed to the reporting currency). Under ASC 830, A's functional currency would change to the reporting currency of its parent (USD) in the period in which A determines that the jurisdiction is highly inflationary (or otherwise determines that its functional currency should be the reporting currency). The USD-translated amount for the equipment at the end of the prior period (December 31, 20X5) becomes the accounting basis in the current period and in subsequent periods. The following table illustrates the tax effects when A changes its functional currency from the local currency to the reporting currency (all amounts are in LC):

<table>
<thead>
<tr>
<th>Tax Basis</th>
<th>Not Recognized Under ASC 740</th>
<th>Recognized Under ASC 740</th>
<th>Book Basis</th>
<th>Temporary Difference</th>
<th>DTA/(DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis on January 1, 20X6</td>
<td>—</td>
<td>862,500</td>
<td>750,000</td>
<td>112,500</td>
<td>45,000</td>
</tr>
<tr>
<td>20X6 depreciation expense</td>
<td>—</td>
<td>287,500</td>
<td>250,000</td>
<td>37,500</td>
<td>(15,000)</td>
</tr>
<tr>
<td>—</td>
<td>575,000</td>
<td>500,000</td>
<td>75,000</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>20X6 indexing</td>
<td>86,250</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>N/A</td>
</tr>
<tr>
<td>Basis on December 31, 20X6</td>
<td>86,250</td>
<td>575,000</td>
<td>500,000</td>
<td>75,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

On December 31, 20X6, A would recognize a DTA of 30,000 LC (temporary difference of 75,000 LC × 40% tax rate). The DTA would be recognized at the average exchange rate (to determine the amount to recognize as an income tax benefit) and would then be remeasured at the exchange rate in effect on December 31, 20X6; any difference between the two amounts would be included in the income statement. Under ASC 830-740-45-1, A may present the transaction gain or loss that results from remeasuring the DTA as deferred tax expense or benefit (rather than as a transaction gain or loss) if such presentation is considered more useful. If reported in that manner, the transaction gain or loss would still be included in the aggregate transaction gain or loss for the period, which would be disclosed in accordance with ASC 830-20-45-1.

In addition, because A's functional currency changed to USD (i.e., the reporting currency of its parent) in 20X6, A would not recognize any deferred taxes related to the additional indexing that occurred in 20X6, since that adjustment was made after the functional currency changed. Further, A would not immediately reverse the DTA that it previously recorded in connection with the 20X5 indexing adjustments before its functional currency changed. Rather, that DTA would be reversed over time as those benefits (in the form of increased tax depreciation expense) are realized on A's tax return. For example, in 20X6, A claimed additional depreciation of 37,500 LC for tax purposes related to the indexation that occurred in 20X5. Because this additional depreciation was realized on the return, A reverses the DTA by the corresponding, tax-effected amount (37,500 LC × 40% = 15,000).
### Example 8-6 — Change in the Functional Currency From the Local Currency to the Reporting Currency (continued)

Further assume that throughout 20X7, the country in which A operates continues to be highly inflationary and that its functional currency therefore continues to be the reporting currency. The following table illustrates A’s tax effects in 20X7 (all amounts are in LC):

<table>
<thead>
<tr>
<th>Tax Basis</th>
<th>Not Recognized Under ASC 740</th>
<th>Recognized Under ASC 740</th>
<th>Book Basis</th>
<th>Temporary Difference</th>
<th>DTA/(DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis on January 1, 20X6</td>
<td>86,250</td>
<td>575,000</td>
<td>500,000</td>
<td>75,000</td>
<td>30,000</td>
</tr>
<tr>
<td>20X6 depreciation expense</td>
<td>43,125</td>
<td>287,500</td>
<td>250,000</td>
<td>37,500</td>
<td>(15,000)</td>
</tr>
<tr>
<td>20X6 indexing</td>
<td>49,594</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>N/A</td>
</tr>
<tr>
<td>Basis on December 31, 20X6</td>
<td>92,719</td>
<td>287,500</td>
<td>250,000</td>
<td>37,500</td>
<td>15,000</td>
</tr>
</tbody>
</table>

In 20X7, A realizes total tax depreciation of 330,625 LC on its tax return (the total of the first and second columns in the table above). However, of the total tax depreciation realized, 43,125 LC is related to the effects of the indexing that occurred in 20X6. Because the indexing occurred after the functional currency changed to the reporting currency, the excess depreciation realized in 20X7 has no impact on the DTA. However, since this amount is realized on the entity’s return, it creates a permanent difference in 20X7, which would lower A’s effective tax rate and current payable (provided that A reported taxable income).

The remainder of the tax depreciation realized in 20X7 (287,500 LC) is related to the tax basis that existed before the functional currency changed to the reporting currency. The amount is the same as the amount calculated in 20X6 and would remain the same in 20X8 (the last year of the asset’s useful life for tax purposes). Because this amount is 37,500 LC higher than the depreciation expense realized for book purposes, A reverses the DTA by the corresponding, tax-effected amount (37,500 LC × 40% = 15,000). The remaining temporary difference of 37,500 LC at the end of 20X7 would be reversed in 20X8.

Entity A does not recognize a DTA for the additional indexing that occurred at the end of 20X7, since that adjustment occurred after the functional currency was changed.

---

3 The amount of depreciation expense related specifically to the 20X6 indexing is calculated by dividing the amount of tax basis created as a result of the indexing (86,250 LC) by the number of years remaining on the asset’s useful life for tax purposes at the time the basis increased (two years). This amount can also be calculated by comparing the amounts of tax depreciation expense before and after the change in functional currency.
8.3.2 Changes From a Different Currency to the Local Currency

**ASC 830-740**

Functional Currency Related Changes

25-2 Subtopic 830-30 requires that a change in functional currency from the reporting currency to the local currency when an economy ceases to be considered highly inflationary shall be accounted for by establishing new functional currency bases for nonmonetary items. Those bases are computed by translating the historical reporting currency amounts of nonmonetary items into the local currency at current exchange rates.

25-3 As a result of applying those requirements, the functional currency bases generally will exceed the local currency tax bases of nonmonetary items. The differences between the new functional currency bases and the tax bases represent temporary differences under Subtopic 740-10, for which deferred taxes shall be recognized. Paragraph 830-740-45-2 addresses the presentation of the effect of recognizing these deferred taxes.

Under ASC 830-740-25-2, when the functional currency of an entity changes from the reporting currency to the local currency because the economy ceases to be considered highly inflationary, the change must be accounted for by establishing new functional-currency-denominated carrying values for nonmonetary items. The entity would establish these carrying values by using current exchange rates to translate the historical amounts (denominated in the “old” functional currency) into the local currency.

Generally, the new functional (local) currency carrying value of a nonmonetary asset or liability will be greater than its tax basis. That is, because of fluctuations in the exchange rate that have occurred since the tax basis was originally established, the two amounts will differ on the date on which the functional currency changes. In accordance with ASC 830-740-25-3, these “differences between the new functional currency [carrying values] and the tax bases represent temporary differences under [ASC] 740, for which deferred taxes shall be recognized.”

Under ASC 830-740-45-2, the deferred taxes associated with the temporary difference that arises should be reflected as an adjustment to the cumulative translation component of OCI rather than as a charge to income. The following example illustrates this concept:

**Example 8-7 — Change in the Functional Currency From the Reporting Currency to the Local Currency**

Entity A, a foreign subsidiary of a U.S. entity, operates in a highly inflationary economy. Therefore, A determines that its functional currency is the reporting currency of its parent (USD) in accordance with ASC 830.

On January 1, 20X1, A purchases equipment with a 10-year useful life for 100,000 LC. The exchange rate on the purchase date is 10 LC to 1 USD, so the U.S.-dollar-equivalent cost is $10,000. On December 31, 20X5, the equipment has a net book value of $5,000 in A’s financial statements (the original cost of $10,000 less accumulated depreciation of $5,000).

On January 1, 20X6, the economy in which A operates ceases to be considered highly inflationary; therefore, A changes its functional currency to the local currency. Thus, in accordance with ASC 830-10-45-15, A must restate the carrying value of the equipment from USD to LC by using the exchange rate in effect on January 1, 20X6. If the exchange rate in effect on January 1, 20X6, is 75 LC to 1 USD, A would restate the carrying value of the equipment as 375,000 LC ($5,000 carrying value × the exchange rate of 75:1).

Because the carrying value of the equipment is restated in LC, a DTL, as measured under the tax laws of the foreign jurisdiction, is recorded in the subsidiary’s financial statements on January 1, 20X6. This DTL is based on the temporary difference between the equipment’s new functional currency carrying value of 375,000 LC and its underlying tax basis of 50,000 LC (the original cost of 100,000 LC less accumulated depreciation of 50,000 LC) on that date.
Example 8-7 — Change in the Functional Currency From the Reporting Currency to the Local Currency (continued)

Thus, if a tax rate of 50 percent in the foreign jurisdiction is assumed, a DTL of 162,500 LC (325,000 LC × 50%) would be recorded. That liability would then be translated to the reporting currency on the basis of the current exchange rate between the USD and LC, and a corresponding charge would be made to the cumulative translation account.

8.4 Price-Level-Related Changes

ASC 830-740

Price-Level-Related Changes

25-4 Entities located in countries with highly inflationary economies may prepare financial statements restated for general price-level changes in accordance with generally accepted accounting principles (GAAP) in the United States. The tax bases of assets and liabilities of those entities are often restated for the effects of inflation.

25-5 When preparing financial statements restated for general price-level changes using end-of-current-year purchasing power units, temporary differences are determined based on the difference between the indexed tax basis amount of the asset or liability and the related price-level restated amount reported in the financial statements. Example 1 (see paragraph 830-740-55-1) illustrates the application of this guidance.

25-6 Temporary differences within an entity’s foreign subsidiaries are referred to as inside basis differences. Differences between the tax basis and the financial reporting basis of an investment in a foreign subsidiary are referred to as outside basis differences.

25-7 Inside basis differences of a foreign subsidiary of a U.S. parent where the local currency is the functional currency may result from foreign laws that provide for the occasional restatement of fixed assets for tax purposes to compensate for the effects of inflation. The amount that offsets the increase in the tax basis of fixed assets is sometimes described as a credit to revaluation surplus, which some view as a component of equity for tax purposes. That amount becomes taxable in certain situations, such as in the event of a liquidation of the foreign subsidiary or if the earnings associated with the revaluation surplus are distributed. In this situation, it is assumed that no mechanisms are available under the tax law to avoid eventual treatment of the revaluation surplus as taxable income. The indefinite reversal criteria of Subtopic 740-30 shall not be applied to inside basis differences of a foreign subsidiary, as indicated in paragraph 740-30-25-17, and a deferred tax liability shall be provided on the amount of the revaluation surplus.

25-8 Paragraph 740-10-25-24 indicates that some temporary differences are deferred taxable income and have balances only on the income tax balance sheet. Therefore, these differences cannot be identified with a particular asset or liability for financial reporting purposes. Because the inside basis difference related to the revaluation surplus results in taxable amounts in future years based on the provisions of the foreign tax law, it qualifies as a temporary difference even though it may be characterized as a component of equity for tax purposes. Subtopic 740-30 clearly limits the indefinite reversal criterion to the temporary differences described in paragraph 740-10-25-3(a) and shall not be applied to analogous types of temporary differences.
Initial Measurement

**ASC 830-740**

**Foreign Financial Statements Restated for General Price Level Changes**

30-1 In foreign financial statements that are restated for general price-level changes, the deferred tax expense or benefit shall be calculated as the difference between the following two measures:

a. Deferred tax assets and liabilities reported at the end of the current year, determined in accordance with paragraph 830-740-25-5

b. Deferred tax assets and liabilities reported at the end of the prior year, remeasured to units of current general purchasing power at the end of the current year.

30-2 The remeasurement of deferred tax assets and liabilities at the end of the prior year is reported together with the remeasurement of all other assets and liabilities as a restatement of beginning equity.

When a foreign entity prepares domestic price-level-adjusted financial statements in accordance with U.S. GAAP, the recognition exception in ASC 740-10-25-3(f) does not apply. The following graphic illustrates the calculation of deferred tax expense or benefit:

![Deferred tax expense (benefit) = End-of-year DTAs and DTLs = Remeasured beginning-of-year DTAs and DTLs](chart.png)

ASC 830-740-55-1 and 55-2 present the following example illustrating the accounting for deferred taxes related to price-level changes:

**ASC 830-740**

55-1 This Example illustrates the guidance in paragraphs 830-740-25-5 and 830-740-30-1 through 30-2. An entity has one asset, a nonmonetary asset that is not depreciated for financial reporting or tax purposes. The local currency is FC. Units of current purchasing power are referred to as CFC. The enacted tax rate is 40 percent. The asset had a price-level-adjusted financial reporting amount of CFC 350 and an indexed basis for tax purposes of CFC 100 at December 31, [20X6], both measured using CFC at December 31, [20X6]. The entity has a taxable temporary difference of CFC 250 (CFC 350 – CFC 100) and a related deferred tax liability of CFC 100 (CFC 250 × 40 percent) using CFC at December 31, [20X6].

55-2 General price levels increase by 50 percent in [20X7], and indexing allowed for [20X7] for tax purposes is 25 percent. At December 31, [20X7], the asset has a price-level-adjusted financial reporting amount of CFC 525 (CFC 350 × 150 percent) and an indexed basis for tax purposes of CFC 125 (CFC 100 × 125 percent), using CFC at December 31, [20X7]. The entity has a taxable temporary difference of CFC 400 (CFC 525 – CFC 125) and a related deferred tax liability of CFC 160 (CFC 400 × 40 percent) at December 31, [20X7], using CFC at December 31, [20X7]. The deferred tax liability at December 31, [20X6] is restated to units of current general purchasing power as of December 31, [20X7]. The restated December 31, [20X6] deferred tax liability is CFC 150 (CFC 100 × 150 percent). For [20X7], the difference between CFC 160 and CFC 150 is reported as deferred tax expense in income from continuing operations. The difference between the deferred tax liability of CFC 100 at December 31, [20X6] and the restated December 31, [20X6] deferred tax liability of CFC 150 is reported in [20X7] as a restatement of beginning equity.
Chapter 9 — Presentation and Disclosure

9.1 Chapter Overview
This chapter summarizes the foreign-currency-related presentation and disclosure requirements for reporting entities, including those in ASC 830 and those that affect SEC registrants.

9.2 Transaction Gains and Losses

<table>
<thead>
<tr>
<th>ASC 830-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement Presentation</td>
</tr>
<tr>
<td>Aggregate Transaction Gain or Loss</td>
</tr>
<tr>
<td>45-1 The aggregate transaction gain or loss included in determining net income for the period shall be disclosed in the financial statements or notes thereto.</td>
</tr>
<tr>
<td>45-2 Certain entities, primarily banks, are dealers in foreign exchange. Although certain gains or losses from dealer transactions may fit the definition of transaction gains or losses in this Subtopic, they may be disclosed as dealer gains or losses rather than as transaction gains or losses.</td>
</tr>
<tr>
<td>Aggregate Transaction Gain or Loss</td>
</tr>
<tr>
<td>50-1 If not disclosed in the financial statements as discussed in paragraph 830-20-45-2, the aggregate transaction gain or loss included in determining net income for the period shall be disclosed in notes to financial statements.</td>
</tr>
</tbody>
</table>

The disclosure required by ASC 830-20-45-1 (see above) should include amounts that (1) may have been appropriately classified within other line items (e.g., sales and cost of sales) and (2) in the case of highly inflationary economies, result from remeasurement from the local currency into the reporting currency (see Section 9.2.3 for further discussion of highly inflationary economies).

Although ASC 830 is silent on the presentation of transaction gains and losses, we believe that the following are two acceptable alternatives for presenting such gains and losses in the income statement:

- Classify transaction gains and losses related to operational activities (e.g., receivables, payables) in income from operations as a separate line item, and classify transaction gains and losses related to debt in other income and expense.
- Classify the aggregate transaction gain or loss as a separate line item in either income from operations or other income and expense.
Chapter 9 — Presentation and Disclosure

The manner in which transaction gains and losses are presented should be disclosed and applied consistently to all periods presented. In providing such disclosures, an entity should consider its specific facts and circumstances as well as what types of information might be most useful to investors. Such information may include:

- The nature of the transactions that resulted in the gains and losses.
- The classification of the gains and losses by line item within the financial statements.
- Support for the classification chosen for the gains and losses.
- The amount of gains or losses included in each line item.

9.2.1 Transaction Gains and Losses Related to Deferred Taxes

**ASC 830-20**

*Change in Deferred Foreign Tax Assets and Liabilities*

**45-3** When the reporting currency (not the foreign currency) is the functional currency, remeasurement of a reporting entity's deferred foreign tax liability or asset after a change in the exchange rate will result in a transaction gain or loss that is recognized currently in determining net income. The preceding paragraph [ASC 830-20-45-2] requires disclosure of the aggregate transaction gain or loss included in determining net income but does not specify how to display that transaction gain or loss or its components for financial reporting. See paragraph 830-740-45-1 for further guidance.

*Income Tax Consequences of Rate Changes*

**45-5** Subtopic 740-10 requires income tax expense to be allocated among income from continuing operations, discontinued operations, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other equity accounts. Some transaction gains and losses are reported in other comprehensive income. Any income taxes related to those transaction gains and losses shall be allocated to other comprehensive income.

**ASC 830-740**

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

ASC 830-740-45-1 indicates that transaction gains and losses related to remeasuring deferred tax balances “may be included in the reported amount of deferred tax benefit or expense if that presentation is considered to be more useful.” Entities that select this presentation method must still include the transaction gain or loss in “the aggregate transaction gain or loss for the period to be disclosed as required by [ASC 830-20-45-1].”
9.2.2 Gains and Losses Related to Long-Term Intra-Entity Transactions in Separate Financial Statements

The exception for long-term intra-entity transactions that is discussed in Section 6.4 applies only to the consolidated entity’s financial statements. A foreign entity (e.g., a subsidiary) would apply the general rules in ASC 830 to its stand-alone financial statements and would record the foreign-currency-related gains and losses associated with such transactions in earnings.

9.2.3 Highly Inflationary Economies

In addition to considering narrative disclosures describing the change to highly inflationary accounting and the impact it may have on the financial statements in general, an entity should consider the impact of such a change on its transaction gains and losses. Therefore, preparers should keep in mind that the requirement in ASC 830-20-45-1 to disclose the aggregate transaction gain or loss presented in the income statement, including the gain or loss attributable to remeasurement due to a highly inflationary economy, still applies.

SEC Considerations

SEC registrants with material operations in a highly inflationary economy should disclose the economy’s status as highly inflationary in their financial statements, even though ASC 830 does not explicitly require such disclosures. Such disclosures should discuss the factors that the entity considered in determining that an economy is highly inflationary as well as the timing of this determination.

Section 6700 of the SEC Financial Reporting Manual contains requirements for foreign issuers operating in hyperinflationary environments and addresses the price-level adjustments that entities need to make when they use a hyperinflationary currency as their reporting currency.

Registrants should also explain the accounting impact of the designation as highly inflationary and the impact the resulting change in functional currency will have on the entity’s financial reporting.

ASC 830-740

45-2 The deferred taxes associated with the temporary differences that arise from a change in functional currency discussed in paragraph 830-740-25-3 when an economy ceases to be considered highly inflationary shall be presented as an adjustment to the cumulative translation adjustments component of shareholders’ equity and therefore shall be recognized in other comprehensive income.

The above guidance notes that deferred taxes that arise because an economy ceases to be considered highly inflationary should be recognized in OCI.

For additional accounting and disclosure considerations related to highly inflationary economies, see Chapter 7.
9.3 Cumulative Translation Adjustment

**Reporting Translation Adjustments**

45-12 If an entity's functional currency is a foreign currency, translation adjustments result from the process of translating that entity's financial statements into the reporting currency. Translation adjustments shall not be included in determining net income but shall be reported in other comprehensive income.

As explained in Chapter 5, adjustments that result from the translation of an entity's financial statements from its functional currency to the reporting currency should be recorded in OCI (i.e., such adjustments do not affect net income).

**9.3.1 Noncontrolling Interests and Equity Method Investments**

**Cumulative Translation Adjustments Attributable to Noncontrolling Interests**

45-17 Accumulated translation adjustments attributable to noncontrolling interests shall be allocated to and reported as part of the noncontrolling interest in the consolidated reporting entity.

For investees that are not wholly owned, the presentation of CTA will depend on whether the parent consolidates the foreign entity investee or accounts for it by using the equity method:

- **Consolidated**
  - Allocate part of the CTA to the NCI
  - See Section 5.3.1

- **Equity method investee**
  - The investor's share of the related CTA is recognized
  - See Section 5.2.2

**9.3.2 Changes in Cumulative Translation Adjustment**

**Analysis of Changes in Cumulative Translation Adjustment**

45-18 An analysis of the changes during the period in the accumulated amount of translation adjustments reported in equity shall be provided in any of the following ways:

- a. In a separate financial statement
- b. In notes to financial statements
- c. As part of a statement of changes in equity.

45-19 This accumulated amount in equity might be titled Equity Adjustment from Foreign Currency Translation or given a similar title.
ASC 830-30 (continued)

**45-20** At a minimum, the analysis shall disclose all of the following:

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

**Analysis of Changes in Cumulative Translation Adjustment**

**50-1** If not provided in a separate financial statement or as part of a statement of changes in equity, an analysis of the changes during the period in the accumulated amount of translation adjustments reported in equity shall be provided in notes to financial statements. At a minimum, the analysis shall disclose the items enumerated in paragraph 830-30-45-20.

As noted in the guidance above, an entity must provide certain disclosures analyzing the changes in the CTA. Such an analysis can be presented in (1) a separate financial statement, (2) the notes to the financial statements, or (3) a statement of changes in equity. Regardless of the format in which the analysis is provided, it must contain the items listed in ASC 830-30-45-20.

**9.3.3 Income Taxes Recorded in Cumulative Translation Adjustment**

**ASC 830-30**

**Reporting Other Comprehensive Income — Income Tax Consequences of Rate Changes**

**45-21** Subtopic 740-10 requires income tax expense to be allocated among income from continuing operations, discontinued operations, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other equity accounts. All translation adjustments are reported in other comprehensive income. Any income taxes related to those translation adjustments shall be allocated to other comprehensive income. Translation adjustments are accounted for in the same way as temporary differences under the provisions of Subtopic 740-10. If under the requirements of Subtopic 740-30 deferred taxes are not provided for unremitting earnings of a subsidiary, in those instances, deferred taxes shall not be provided on translation adjustments.

Deferred taxes should “not be provided for [the] translation adjustments” discussed in ASC 830-30-45-21. Specifically, ASC 740-30-25-17 explains that “no income taxes shall be accrued by the parent entity . . . if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation.”

**Example 9-1 — Deferred Taxes Related to Translation Adjustments**

Company N is a domestic corporation with a wholly owned subsidiary, S, operating in a foreign tax jurisdiction. The functional currency of S is the local currency and, historically, no earnings have been repatriated to N because the parent company considers its investment to be permanent.

In this case, deferred income tax assets and liabilities should not be recognized for the adjustment resulting from translation of S’s financial statements into USD.
9.4 Exchange Rate Changes

**ASC 830-20**

**Subsequent Rate Changes**

50-2 Disclosure of a rate change that occurs after the date of the reporting entity's financial statements and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary. If disclosed, the disclosure shall include consideration of changes in unsettled transactions from the date of the financial statements to the date the rate changed. In some cases it may not be practicable to determine these changes; if so, that fact shall be stated.

**Effects of Rate Changes on Results of Operations**

50-3 Management is encouraged to supplement the disclosures required by this Subtopic with an analysis and discussion of the effects of rate changes on the reported results of operations. This type of disclosure might include the mathematical effects of translating revenue and expenses at rates that are different from those used in a preceding period as well as the economic effects of rate changes, such as the effects on selling prices, sales volume, and cost structures. The purpose is to assist financial report users in understanding the broader economic implications of rate changes and to compare recent results with those of prior periods.

**ASC 830-30**

**Subsequent Change in Exchange Rate**

45-16 A reporting entity's financial statements shall not be adjusted for a rate change that occurs after the date of the reporting entity's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the reporting entity.

**Subsequent Rate Changes**

50-2 Disclosure of a rate change that occurs after the date of the reporting entity's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the reporting entity and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary.
As indicated in the guidance above, an entity should not adjust its financial statements for a rate change that occurs after the date of its financial statements (except in situations in which there is significant devaluation for subsidiaries reporting on a lag, as discussed in Section 3.3.1). However, disclosures related to such a rate change may be warranted depending on the change's significance as well as its impact on foreign currency transactions that remain unsettled as of the balance sheet date. Such disclosures may include discussion of the effects of changes in exchange rates on the following:

- Results of operations.
- Selling prices.
- Sales volume.
- Cost structures.

The purpose of such disclosures is to help financial statement users understand the overall effects of changes in exchange rates on an entity's cash flows and net income. If there are no unsettled foreign currency transactions as of the balance sheet date, an entity is not required to provide such disclosures since any change in exchange rates would only affect subsequent translation adjustments, which do not affect net income or cash flows (i.e., translation adjustments are recorded in equity).

**SEC Considerations**

We believe that if the impact of a change in exchange rates is expected to significantly affect an SEC registrant's future cash flows, the registrant should disclose this fact in its MD&A.

As with disclosures about the effects of post-balance-sheet rate changes, ASC 830-20-50-3 notes that an entity is “encouraged to supplement the [required] disclosures” with additional analysis of the effects that changes in exchange rates have had on the entity's operations within the current reporting period. Such an analysis may include the effects of changes in exchange rates on the items listed above along with the effect of changes on items such as the translation of revenue and expenses at rates different from those used in prior periods.

Such supplemental disclosures may “assist financial report users in understanding the broader economic implications of rate changes and to compare recent results with those of prior periods.”

**SEC Considerations**

If a foreign government officially changes a fixed exchange rate and this change causes the local currency to decline with respect to other currencies, the SEC is likely to expect registrants to include appropriate disclosures about the event in MD&A. See Section 7.3 for information about disclosures that may be appropriate, depending on an entity's particular facts and circumstances.

### 9.5 Highly Inflationary Economies

The SEC staff continues to focus on accounting and disclosure considerations related to the foreign currency exchange environment in countries whose economies (1) are highly inflationary (e.g., Venezuela) or (2) risk becoming highly inflationary (e.g., Argentina). For example, accounting questions may arise regarding (1) which exchange rate is appropriate for remeasurement and (2) whether business operations should be deconsolidated or considered impaired. For more information about the recent scrutiny related to highly inflationary economies, see Chapter 7 and Appendix B.
9.6 Statement of Cash Flows

ASC 830-230

45-1 A statement of cash flows of an entity with foreign currency transactions or foreign operations shall 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 if the rates at the dates of the cash flows were used. (That is, paragraph 830-30-45-3 applies to cash receipts and cash payments.) The statement of cash flows shall report the effect of exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of the change in cash and cash equivalents during the period. See Example 1 (paragraph 830-230-55-1) for an illustration of this guidance.

Pending Content (Transition Guidance: ASC 230-10-65-3)

45-1 A statement of cash flows of an entity with foreign currency transactions or foreign operations shall 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 if the rates at the dates of the cash flows were used. (That is, paragraph 830-30-45-3 applies to cash receipts and cash payments.) The statement of cash flows shall 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 part of 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. See Example 1 (paragraph 830-230-55-1) for an illustration of this guidance.

Entities may have transactions that are denominated in a foreign currency or businesses that operate in foreign currency environments. An entity should report the cash flow effects of transactions denominated in a foreign currency by using the exchange rates in effect on the date of such cash flows. As noted above, instead of using the actual exchange rate on the date of a foreign currency transaction, an entity may use an “appropriately weighted average exchange rate” for translation “if the result is substantially the same as if the rates at the dates of the cash flows were used.”

A consolidated entity with operations whose functional currencies are foreign currencies may use the following approach when preparing its consolidated statement of cash flows:

• Prepare a separate statement of cash flows for each foreign entity by using the operation's functional currency.
• Translate the stand-alone cash flow statement prepared in the functional currency of each foreign entity into the reporting currency of the parent entity.
• Consolidate the individual translated statements of cash flows.

The effects of exchange rate changes, or translation gains and losses, are not the same as the effects of transaction gains and losses and should not be presented or calculated in the same manner.

Effects of exchange rate changes may directly affect cash receipts and payments but do not directly result in cash flows themselves.

Because unrealized transaction gains and losses arising from the remeasurement of foreign-currency-denominated monetary assets and liabilities on the balance sheet date are included in the determination of net income, such amounts should be presented as a reconciling item between net income and net cash from operating activities (either on the face of the statement under the indirect method or in a separate schedule under the direct method).
Subsequently, any cash flows arising from the settlement of the foreign-currency-denominated asset and liability should be presented in the statement of cash flows as an operating, investing, or financing activity on the basis of the nature of such cash flows.

Translation gains and losses, however, are recognized in OCI and are not included in cash flows from operating, investing, or financing activities.

The effects of exchange rate changes on cash should be shown as a separate line item in the statement of cash flows as part of the reconciliation of beginning and ending cash balances. This issue was discussed in paragraph 101 of the Basis for Conclusions of FASB Statement 95, which stated, in part:

The effects of exchange rate changes on assets and liabilities denominated in foreign currencies, like those of other price changes, may affect the amount of a cash receipt or payment. But exchange rate changes do not themselves give rise to cash flows, and their effects on items other than cash thus have no place in a statement of cash flows. To achieve its objective, a statement of cash flows should reflect the reporting currency equivalent of cash receipts and payments that occur in a foreign currency. Because the effect of exchange rate changes on the reporting currency equivalent of cash held in foreign currencies affects the change in an enterprise’s cash balance during a period but is not a cash receipt or payment, the Board decided that the effect of exchange rate changes on cash should be reported as a separate item in the reconciliation of beginning and ending balances of cash. [Emphasis added]

In a manner consistent with the implementation guidance in ASC 830-230-55-15, the effect of exchange rate changes on cash and cash equivalents is the sum of the following two components:

1. For each foreign operation, the difference between the exchange rates used in translating functional currency cash flows and the exchange rate at year-end multiplied by the net cash flow activity for the period measured in the functional currency.

2. The fluctuation in the exchange rates from the beginning of the year to the end of the year multiplied by the beginning cash balance denominated in currencies other than the reporting currency.

Example 1 in ASC 830-230-55-1 through 55-15 illustrates the computation of the effect of exchange rate changes on cash:

---

**ASC 830-230**

**Illustrations**

*Example 1: Statement of Cash Flows for Manufacturing Entity With Foreign Operations*

55-1 This Example illustrates a statement of cash flows under the direct method for a manufacturing entity with foreign operations. The illustrations of the reconciliation of net income to net cash provided by operating activities may provide detailed information in excess of that required for a meaningful presentation. Other formats or levels of detail may be appropriate for particular circumstances.
The following is a consolidating statement of cash flows for the year ended December 31, 19X1, for Entity F, a multinational U.S. corporation engaged principally in manufacturing activities, which has two wholly owned foreign subsidiaries—Subsidiary A and Subsidiary B. For Subsidiary A, the local currency is the functional currency. For Subsidiary B, which operates in a highly inflationary economy, the U.S. dollar is the functional currency.

**Entity F**  
**Consolidating Statement of Cash Flows**  
**For the Year Ended December 31, 19X1**

<table>
<thead>
<tr>
<th>Increase (Decrease) in Cash and Cash Equivalents</th>
<th>Parent Entity</th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
<th>Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash flows from operating activities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>$4,610(^{(a)})</td>
<td>$888(^{(a)})</td>
<td>$561(^{(a)})</td>
<td>$(430)</td>
<td>$5,629</td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>(3,756)(^{(a)})</td>
<td>(806)(^{(a)})</td>
<td>(370)(^{(a)})</td>
<td>(430)</td>
<td>(4,502)</td>
</tr>
<tr>
<td>Interest paid</td>
<td>(170)</td>
<td>(86)</td>
<td>(135)</td>
<td>–</td>
<td>(391)</td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(158)</td>
<td>(25)</td>
<td>(21)</td>
<td>–</td>
<td>(204)</td>
</tr>
<tr>
<td>Interest and dividends received</td>
<td>57</td>
<td>–</td>
<td>–</td>
<td>(22)</td>
<td>35</td>
</tr>
<tr>
<td>Miscellaneous cash received (paid)</td>
<td>–</td>
<td>45</td>
<td>(5)</td>
<td>–</td>
<td>40</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>583</td>
<td>16</td>
<td>30</td>
<td>(22)</td>
<td>607</td>
</tr>
<tr>
<td><strong>Cash flows from investing activities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of equipment</td>
<td>150</td>
<td>116</td>
<td>14</td>
<td>–</td>
<td>280</td>
</tr>
<tr>
<td>Payments for purchase of equipment</td>
<td>(450)</td>
<td>(258)</td>
<td>(15)</td>
<td>–</td>
<td>(723)</td>
</tr>
<tr>
<td>Net cash used in investing activities</td>
<td>(300)</td>
<td>(142)</td>
<td>(1)</td>
<td>–</td>
<td>(443)</td>
</tr>
<tr>
<td><strong>Cash flows from financing activities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from issuance of short-term debt</td>
<td>20</td>
<td>75</td>
<td>–</td>
<td>–</td>
<td>95</td>
</tr>
<tr>
<td>Intra-entity loan</td>
<td>(15)</td>
<td>–</td>
<td>15</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Proceeds from issuance of long-term debt</td>
<td>–</td>
<td>165</td>
<td>–</td>
<td>–</td>
<td>165</td>
</tr>
<tr>
<td>Repayment of long-term debt</td>
<td>(200)</td>
<td>(105)</td>
<td>(35)</td>
<td>–</td>
<td>(340)</td>
</tr>
<tr>
<td>Payment of dividends</td>
<td>(120)</td>
<td>–</td>
<td>22</td>
<td>–</td>
<td>(120)</td>
</tr>
<tr>
<td>Net cash provided by (used in) financing activities</td>
<td>(315)</td>
<td>113</td>
<td>(20)</td>
<td>22</td>
<td>(200)</td>
</tr>
<tr>
<td>Effect of exchange rate changes on cash</td>
<td>–</td>
<td>9(^{(b)})</td>
<td>(5)(^{(b)})</td>
<td>–</td>
<td>4</td>
</tr>
<tr>
<td>Net change in cash and cash equivalents</td>
<td>(32)</td>
<td>(4)</td>
<td>4</td>
<td>–</td>
<td>(32)</td>
</tr>
<tr>
<td>Cash and cash equivalents at beginning of year</td>
<td>255</td>
<td>15</td>
<td>5</td>
<td>–</td>
<td>275</td>
</tr>
<tr>
<td>Cash and cash equivalents at end of year</td>
<td>$223</td>
<td>$11</td>
<td>$9</td>
<td>–</td>
<td>$243</td>
</tr>
</tbody>
</table>

\(^{(a)}\) The computation of this amount is provided in paragraph 830-230-55-14.

\(^{(b)}\) The computation of this amount is provided in paragraph 830-230-55-15.
Reconciliation of net income to net cash provided by operating activities:

<table>
<thead>
<tr>
<th></th>
<th>Parent Entity</th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
<th>Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$ 417</td>
<td>$ 50</td>
<td>$ (66)</td>
<td>$ (37)</td>
<td>$ 364</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash provided by operating activities:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>350</td>
<td>85</td>
<td>90</td>
<td>–</td>
<td>525</td>
</tr>
<tr>
<td>(Gain) loss on sale of equipment</td>
<td>(115)</td>
<td>–</td>
<td>25</td>
<td>–</td>
<td>(90)</td>
</tr>
<tr>
<td>Writedown of facility to net realizable value</td>
<td>50</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>50</td>
</tr>
<tr>
<td>Exchange gain</td>
<td>–</td>
<td>–</td>
<td>(115)</td>
<td>–</td>
<td>(115)</td>
</tr>
<tr>
<td>Provision for deferred taxes</td>
<td>90</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>90</td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(85)</td>
<td>(37)</td>
<td>(9)</td>
<td>–</td>
<td>(131)</td>
</tr>
<tr>
<td>(Increase) decrease in inventory</td>
<td>(80)</td>
<td>(97)</td>
<td>107</td>
<td>15</td>
<td>(55)</td>
</tr>
<tr>
<td>Increase (decrease) in accounts payable and accrued expenses</td>
<td>(41)</td>
<td>16</td>
<td>(6)</td>
<td>–</td>
<td>(31)</td>
</tr>
<tr>
<td>Increase (decrease) in interest and taxes payable</td>
<td>(3)</td>
<td>(1)</td>
<td>4</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$ 583</td>
<td>$ 16</td>
<td>$ 30</td>
<td>$ (22)</td>
<td>$ 607</td>
</tr>
</tbody>
</table>

The entity would make the following disclosure.

Cash in excess of daily requirements is invested in marketable securities consisting of U.S. Treasury bills with maturities of three months or less. Such investments are deemed to be cash equivalents for purposes of the statement of cash flows.
Summarized in the following tables is financial information for the current year for Entity F, which provides the basis for the statement of cash flows presented in paragraph 830-230-55-2.

### Entity F

#### Consolidating Statement of Financial Position

**December 31, 19X1**

<table>
<thead>
<tr>
<th></th>
<th>Parent Entity</th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
<th>Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$233</td>
<td>$11</td>
<td>$9</td>
<td>–</td>
<td>$243</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>725</td>
<td>95</td>
<td>20</td>
<td>–</td>
<td>840</td>
</tr>
<tr>
<td>Intra-entity loan receivable</td>
<td>15</td>
<td>–</td>
<td>–</td>
<td>(15)</td>
<td>–</td>
</tr>
<tr>
<td>Inventory</td>
<td>630</td>
<td>281</td>
<td>96</td>
<td>(15)</td>
<td>992</td>
</tr>
<tr>
<td>Investments</td>
<td>730</td>
<td>–</td>
<td>–</td>
<td>(730)</td>
<td>–</td>
</tr>
<tr>
<td>Property, plant, and equipment, net</td>
<td>3,305</td>
<td>1,441</td>
<td>816</td>
<td>–</td>
<td>5,562</td>
</tr>
<tr>
<td>Other assets</td>
<td>160</td>
<td>11</td>
<td>–</td>
<td>–</td>
<td>171</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$5,788</td>
<td>$1,839</td>
<td>$941</td>
<td>(760)</td>
<td>$7,808</td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>$529</td>
<td>$135</td>
<td>$38</td>
<td>–</td>
<td>$702</td>
</tr>
<tr>
<td>Interest payable</td>
<td>35</td>
<td>11</td>
<td>4</td>
<td>–</td>
<td>50</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>45</td>
<td>5</td>
<td>2</td>
<td>–</td>
<td>52</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>160</td>
<td>135</td>
<td>–</td>
<td>–</td>
<td>295</td>
</tr>
<tr>
<td>Intra-entity debt</td>
<td>–</td>
<td>–</td>
<td>15</td>
<td>(15)</td>
<td>–</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,100</td>
<td>315</td>
<td>40</td>
<td>–</td>
<td>1,455</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>342</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>342</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>2,211</td>
<td>601</td>
<td>99</td>
<td>(15)</td>
<td>2,896</td>
</tr>
<tr>
<td><strong>Stockholders' equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td>550</td>
<td>455</td>
<td>275</td>
<td>(730)</td>
<td>550</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,027</td>
<td>554</td>
<td>567</td>
<td>(15)</td>
<td>4,133</td>
</tr>
<tr>
<td>Cumulative translation adjustment</td>
<td>–</td>
<td>229</td>
<td>–</td>
<td>–</td>
<td>229</td>
</tr>
<tr>
<td><strong>Total stockholders' equity</strong></td>
<td>3,577</td>
<td>1,238</td>
<td>842</td>
<td>(745)</td>
<td>4,912</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders' equity</strong></td>
<td>$5,788</td>
<td>$1,839</td>
<td>$941</td>
<td>(760)</td>
<td>$7,808</td>
</tr>
</tbody>
</table>
### Entity F

**Consolidating Statement of Income**

**For the Year Ended December 31, 19X1**

<table>
<thead>
<tr>
<th></th>
<th>Parent Entity</th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
<th>Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$4,695</td>
<td>$925</td>
<td>$570</td>
<td>($430)</td>
<td>$5,760</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(3,210)</td>
<td>(615)</td>
<td>(406)</td>
<td>-</td>
<td>(3,816)</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>(350)</td>
<td>(85)</td>
<td>(90)</td>
<td>-</td>
<td>(525)</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>(425)</td>
<td>(110)</td>
<td>(65)</td>
<td>-</td>
<td>(600)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(165)</td>
<td>(90)</td>
<td>(135)</td>
<td>-</td>
<td>(390)</td>
</tr>
<tr>
<td>Interest and dividend income</td>
<td>57</td>
<td>-</td>
<td>-</td>
<td>(22)</td>
<td>35</td>
</tr>
<tr>
<td>Gain (loss) on sale of equipment</td>
<td>115</td>
<td>-</td>
<td>(25)</td>
<td>-</td>
<td>90</td>
</tr>
<tr>
<td>Miscellaneous income (expense)</td>
<td>(50)</td>
<td>45</td>
<td>(5)</td>
<td>-</td>
<td>(10)</td>
</tr>
<tr>
<td>Exchange gain</td>
<td>-</td>
<td>-</td>
<td>115</td>
<td>-</td>
<td>115</td>
</tr>
<tr>
<td>Increase before income taxes</td>
<td>667</td>
<td>70</td>
<td>(41)</td>
<td>(37)</td>
<td>659</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>(250)</td>
<td>(20)</td>
<td>(25)</td>
<td>-</td>
<td>(295)</td>
</tr>
<tr>
<td>Net income</td>
<td>$417</td>
<td>$50</td>
<td>($66)</td>
<td>($37)</td>
<td>$364</td>
</tr>
</tbody>
</table>

*55-5* The U.S. dollar equivalents of one unit of local currency applicable to Subsidiary A and to Subsidiary B are as follows.

<table>
<thead>
<tr>
<th></th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>.40</td>
<td>.05</td>
</tr>
<tr>
<td>Weighted average</td>
<td>.43</td>
<td>.03</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>.45</td>
<td>.02</td>
</tr>
</tbody>
</table>

*55-6* The computation of the weighted-average exchange rate for Subsidiary A excludes the effect of Subsidiary A's sale of inventory to the parent entity at the beginning of the year discussed in paragraph 830-230-55-10(a).
Comparative statements of financial position for the parent entity and for each of the foreign subsidiaries are as follows.

### Comparative Statements of Financial Position

<table>
<thead>
<tr>
<th></th>
<th>Parent Entity</th>
<th>Subsidiary A</th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
<th>Subsidiary B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>U.S. Dollars (USD)</td>
<td>Local Currency (LC)</td>
<td>U.S. Dollars (USD)</td>
<td>Local Currency (LC)</td>
<td>U.S. Dollars (USD)</td>
</tr>
<tr>
<td></td>
<td>1/1/X1</td>
<td>12/31/X1</td>
<td>Change</td>
<td>1/1/X1</td>
<td>12/31/X1</td>
</tr>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>255</td>
<td>223</td>
<td>(32)</td>
<td>38</td>
<td>25</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>640</td>
<td>725</td>
<td>85</td>
<td>125</td>
<td>210</td>
</tr>
<tr>
<td>Intra-entity loan receivable</td>
<td>—</td>
<td>15</td>
<td>15</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Inventory</td>
<td>550</td>
<td>630</td>
<td>80</td>
<td>400</td>
<td>625</td>
</tr>
<tr>
<td>Investments</td>
<td>730</td>
<td>730</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Property, plant, and equipment, net</td>
<td>3,280</td>
<td>3,305</td>
<td>25</td>
<td>3,075</td>
<td>3,202</td>
</tr>
<tr>
<td>Other assets</td>
<td>170</td>
<td>160</td>
<td>(10)</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>5,625</td>
<td>5,788</td>
<td>163</td>
<td>3,663</td>
<td>4,087</td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>570</td>
<td>529</td>
<td>(41)</td>
<td>263</td>
<td>300</td>
</tr>
<tr>
<td>Interest payable</td>
<td>40</td>
<td>35</td>
<td>(5)</td>
<td>15</td>
<td>24</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>43</td>
<td>45</td>
<td>2</td>
<td>25</td>
<td>12</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>140</td>
<td>160</td>
<td>20</td>
<td>125</td>
<td>300</td>
</tr>
<tr>
<td>Intra-entity debt</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,300</td>
<td>1,100</td>
<td>(200)</td>
<td>550</td>
<td>700</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>252</td>
<td>342</td>
<td>90</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>2,345</td>
<td>2,211</td>
<td>(134)</td>
<td>978</td>
<td>1,336</td>
</tr>
<tr>
<td><strong>Stockholders’ equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td>550</td>
<td>550</td>
<td>—</td>
<td>1,300</td>
<td>1,300</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,730</td>
<td>3,027</td>
<td>297</td>
<td>1,385</td>
<td>1,451</td>
</tr>
<tr>
<td>Cumulative translation adjustment</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td>3,280</td>
<td>3,577</td>
<td>297</td>
<td>2,685</td>
<td>2,751</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td>5,625</td>
<td>5,788</td>
<td>163</td>
<td>3,663</td>
<td>4,087</td>
</tr>
</tbody>
</table>
Statements of Income
For the Year Ended December 31, 19X1

<table>
<thead>
<tr>
<th></th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Local Currency</td>
<td>U.S. Dollars</td>
</tr>
<tr>
<td>Revenues</td>
<td>LC 2,179</td>
<td>USD 925(a)</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(1,458)</td>
<td>(615)(b)</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>(198)</td>
<td>(85)</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>(256)</td>
<td>(110)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(209)</td>
<td>(90)</td>
</tr>
<tr>
<td>Gain (loss) on sale of equipment</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Miscellaneous income (expense)</td>
<td>105</td>
<td>45</td>
</tr>
<tr>
<td>Exchange gain</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>163</td>
<td>70</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>(47)</td>
<td>(20)</td>
</tr>
<tr>
<td>Net income</td>
<td>LC 116</td>
<td>USD 50</td>
</tr>
</tbody>
</table>

(a) This amount was computed as follows:
- Sale to parent entity at beginning of year: LC 400 @ .40 = USD 160
- Sales to customers: LC 1,779 @ .43 = USD 765
- Total sales in U.S. dollars: USD 925

(b) This amount was computed as follows:
- Cost of sale to parent entity at beginning of year: LC 400 @ .40 = USD 160
- Cost of sales to customers: LC 1,058 @ .43 = USD 455
- Total cost of sales in U.S. dollars: USD 615
All of the following transactions were entered into during the year by the parent entity and are reflected in
the preceding financial statements:

a. The parent entity invested cash in excess of daily requirements in U.S. Treasury bills. Interest earned on
such investments totaled USD 35.
b. The parent entity sold excess property with a net book value of USD 35 for USD 150.
c. The parent entity's capital expenditures totaled USD 450.
d. The parent entity wrote down to its estimated net realizable value of USD 25 a facility with a net book
value of USD 75.
e. The parent entity's short-term debt consisted of commercial paper with maturities not exceeding 60
days.
f. The parent entity repaid long-term notes of USD 200.
g. The parent entity’s depreciation totaled USD 340, and amortization of intangible assets totaled USD 10.
h. The parent entity’s provision for income taxes included deferred taxes of USD 90.
i. Because of a change in product design, the parent entity purchased all of Subsidiary A’s beginning
inventory for its book value of USD 160. All of the inventory was subsequently sold by the parent entity.
j. The parent entity received a dividend of USD 22 from Subsidiary A. The dividend was credited to the
parent entity's income.
k. The parent entity purchased from Subsidiary B USD 270 of merchandise of which USD 45 remained in
the parent entity’s inventory at year-end. Intra-entity profit on the remaining inventory totaled USD 15.
l. The parent entity loaned USD 15, payable in U.S. dollars, to Subsidiary B.
m. Entity F paid dividends totaling USD 120 to shareholders.

All of the following transactions were entered into during the year by Subsidiary A and are reflected in
the above financial statements. The U.S. dollar equivalent of the local currency amount based on the exchange
rate at the date of each transaction is included. Except for the sale of inventory to the parent entity (the
transaction in [a]), Subsidiary A’s sales and purchases and operating cash receipts and payments occurred
evenly throughout the year.

a. Because of a change in product design, Subsidiary A sold all of its beginning inventory to the parent
entity for its book value of LC 400 (USD 160).
b. Subsidiary A sold equipment for its book value of LC 275 (USD 116) and purchased new equipment at a
cost of LC 600 (USD 258).
c. Subsidiary A issued an additional LC 175 (USD 75) of 30-day notes and renewed the notes at each
maturity date.
d. Subsidiary A issued long-term debt of LC 400 (USD 165) and repaid long-term debt of LC 250 (USD 105).
e. Subsidiary A paid a dividend to the parent entity of LC 50 (USD 22).
The following transactions were entered into during the year by Subsidiary B and are reflected in the preceding financial statements. The U.S. dollar equivalent of the local currency amount based on the exchange rate at the date of each transaction is included. Subsidiary B’s sales and operating cash receipts and payments occurred evenly throughout the year. For convenience, all purchases of inventory were based on the weighted-average exchange rate for the year. Subsidiary B uses the first-in, first-out (FIFO) method of inventory valuation.

a. Subsidiary B had sales to the parent entity as follows.

<table>
<thead>
<tr>
<th>Local Currency</th>
<th>U.S. Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intra-entity sales</td>
<td>LC 9,000 USD 270</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(4,500) (180)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>LC 4,500 USD 90</td>
</tr>
</tbody>
</table>

b. Subsidiary B sold equipment with a net book value of LC 200 (USD 39) for LC 350 (USD 14). New equipment was purchased at a cost of LC 500 (USD 15).

c. Subsidiary B borrowed USD 15 (LC 500), payable in U.S. dollars, from the parent entity.

d. Subsidiary B repaid LC 1,000 (USD 35) of long-term debt.
### ASC 830-230 (continued)

#### 55-12 Statements of cash flows in the local currency and in U.S. dollars for Subsidiary A and Subsidiary B are as follows.

<table>
<thead>
<tr>
<th>Statements of Cash Flows</th>
<th>For the Year Ended December 31, 19X1</th>
<th>Increase (Decrease) in Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Subsidiary A</strong></td>
<td><strong>Subsidiary B</strong></td>
</tr>
<tr>
<td></td>
<td>Local Currency</td>
<td>U.S. Dollars</td>
</tr>
<tr>
<td><strong>Cash flows from operating activities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>LC 2,094&lt;sup&gt;(a)&lt;/sup&gt;</td>
<td>USD 888&lt;sup&gt;(a)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>(1,902)&lt;sup&gt;(a)&lt;/sup&gt;</td>
<td>(866)&lt;sup&gt;(a)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Interest paid</td>
<td>(200)</td>
<td>(86)&lt;sup&gt;(b)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(60)</td>
<td>(25)&lt;sup&gt;(b)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Miscellaneous receipts (payments)</td>
<td>105</td>
<td>(45)&lt;sup&gt;(b)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>37</td>
<td>16</td>
</tr>
<tr>
<td><strong>Cash flows from investing activities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of equipment</td>
<td>275</td>
<td>116&lt;sup&gt;(c)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Payments for purchase of equipment</td>
<td>(600)</td>
<td>(258)&lt;sup&gt;(c)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Net cash used in investing activities</td>
<td>(325)</td>
<td>(142)</td>
</tr>
<tr>
<td><strong>Cash flows from financing activities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net increase in short-term debt</td>
<td>175</td>
<td>75&lt;sup&gt;(c)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Proceeds from intra-entity loan</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Proceeds from issuance of long-term debt</td>
<td>400</td>
<td>165&lt;sup&gt;(c)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Repayment of long-term debt</td>
<td>(250)</td>
<td>(105)&lt;sup&gt;(c)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Payment of dividends</td>
<td>(50)</td>
<td>(22)&lt;sup&gt;(c)&lt;/sup&gt;</td>
</tr>
<tr>
<td>Net cash provided by (used in) financing activities</td>
<td>275</td>
<td>113</td>
</tr>
<tr>
<td><strong>Effect of exchange rate changes on cash</strong></td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td><strong>Net increase (decrease) in cash</strong></td>
<td>(13)</td>
<td>(4)</td>
</tr>
<tr>
<td>Cash at beginning of year</td>
<td>38</td>
<td>15</td>
</tr>
<tr>
<td>Cash at end of year</td>
<td>LC 25</td>
<td>USD 11</td>
</tr>
</tbody>
</table>

<sup>(a)</sup> The computation of this amount is provided in paragraph 830-230-55-14.

<sup>(b)</sup> This amount represents the U.S. dollar equivalent of the foreign currency cash flow based on the weighted-average exchange rate for the year.

<sup>(c)</sup> This amount represents the U.S. dollar equivalent of the foreign currency cash flow based on the exchange rate in effect at the time of the cash flow.

<sup>(d)</sup> The computation of this amount is provided in paragraph 830-230-55-15.
### ASC 830-230 (continued)

55-13 A reconciliation of net income to net cash provided by operating activities follows.

<table>
<thead>
<tr>
<th>Subsidiary A</th>
<th></th>
<th>Subsidiary B</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Local Currency</strong></td>
<td><strong>U.S. Dollars</strong></td>
<td><strong>Local Currency</strong></td>
<td><strong>U.S. Dollars</strong></td>
</tr>
<tr>
<td>Net income</td>
<td>LC</td>
<td>116</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td></td>
<td>LC</td>
<td>1,229</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash provided by operating activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>198</td>
<td>85&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>(Gain) loss on sale of equipment</td>
<td>–</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Exchange gain</td>
<td>–</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(85)</td>
<td>(37)&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>Increase (decrease) in inventory</td>
<td>(225)</td>
<td>(97)&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>Increase (decrease) in accounts payable and accrued expenses</td>
<td>37</td>
<td>16&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>Increase (decrease) in interest and taxes payable</td>
<td>(4)</td>
<td>(1)&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>LC</td>
<td>37</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td>LC</td>
<td>999</td>
<td>USD</td>
</tr>
</tbody>
</table>

<sup>a</sup> This amount represents the U.S. dollar equivalent of the foreign currency amount based on the weighted-average exchange rate for the year.

<sup>b</sup> This amount represents the U.S. dollar equivalent of the foreign currency amount based on historical exchange rates.

<sup>c</sup> This amount represents the exchange gain included in net income as a result of remeasuring Subsidiary B’s financial statements from the local currency to U.S. dollars.

<sup>d</sup> This amount represents the difference between beginning and ending inventory after remeasurement into U.S. dollars based on historical exchange rates.
The following is the computation of cash received from customers and cash paid to suppliers and employees as reported in the consolidating statement of cash flows for Entity F appearing in paragraph 830-230-55-2.

<table>
<thead>
<tr>
<th>Cash received from customers during the year</th>
<th>Parent Entity</th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>USD 4,695</td>
<td>LC 2,179</td>
<td>USD 925 USD 570</td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(85)</td>
<td>(85)</td>
<td>(37)</td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>USD 4,610</td>
<td>LC 2,094</td>
<td>USD 888 USD 561</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash paid to suppliers and employees during the year</th>
<th>Parent Entity</th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>USD 3,210</td>
<td>LC 1,458</td>
<td>USD 615 USD 406</td>
</tr>
<tr>
<td>Effect of exchange rate changes on cost of sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>425</td>
<td>256</td>
<td>110 65</td>
</tr>
<tr>
<td>Total operating expenses requiring cash payments</td>
<td>3,635</td>
<td>1,714</td>
<td>725 355</td>
</tr>
<tr>
<td>Increase in inventory</td>
<td>80</td>
<td>225</td>
<td>97 9</td>
</tr>
<tr>
<td>(Increase) decrease in accounts payable and accrued expenses</td>
<td>41</td>
<td>(37)</td>
<td>(16) 6</td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>USD 3,756</td>
<td>LC 1,902</td>
<td>USD 806 USD 370</td>
</tr>
</tbody>
</table>

\[\text{a)}\] This adjustment represents the difference between cost of sales remeasured at historical exchange rates (USD 406) and cost of sales translated based on the weighted-average exchange rate for the year (USD 290). The adjustment is necessary because cash payments for inventory, which were made evenly throughout the year, were based on the weighted-average exchange rate for the year.
The following is the computation of the effect of exchange rate changes on cash for Subsidiary A and Subsidiary B.

### Computation of Effect of Exchange Rate Changes on Cash

<table>
<thead>
<tr>
<th></th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Effect on beginning cash balance:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning cash balance in local currency</td>
<td>LC 38</td>
<td>LC 100</td>
</tr>
<tr>
<td>Net change in exchange rate during the year</td>
<td>× 0.05</td>
<td>× (0.03)</td>
</tr>
<tr>
<td>Effect on beginning cash balance USD</td>
<td>2</td>
<td>(3)</td>
</tr>
<tr>
<td><strong>Effect from operating activities during the year:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash provided by operating activities in local currency</td>
<td>LC 37</td>
<td>LC 999</td>
</tr>
<tr>
<td>Year-end exchange rate</td>
<td>× 0.45</td>
<td>× 0.02</td>
</tr>
<tr>
<td>Operating cash flows based on year-end exchange rate</td>
<td>USD 16(a)</td>
<td>USD 20</td>
</tr>
<tr>
<td>Operating cash flows reported in the statement of cash flows</td>
<td>16</td>
<td>30</td>
</tr>
<tr>
<td>Effect from operating activities during the year</td>
<td>–</td>
<td>(10)</td>
</tr>
<tr>
<td><strong>Effect from investing activities during the year:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash used in investing activities in local currency</td>
<td>LC (325)</td>
<td>LC (150)</td>
</tr>
<tr>
<td>Year-end exchange rate</td>
<td>× 0.45</td>
<td>× 0.02</td>
</tr>
<tr>
<td>Investing cash flows based on year-end exchange rate</td>
<td>USD (146)</td>
<td>USD (3)</td>
</tr>
<tr>
<td>Investing cash flows reported in the statement of cash flows</td>
<td>(142)</td>
<td>(1)</td>
</tr>
<tr>
<td>Effect from investing activities during the year</td>
<td>(4)</td>
<td>(2)</td>
</tr>
<tr>
<td><strong>Effect from financing activities during the year:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash provided by (used in) financing activities in local currency</td>
<td>LC 275</td>
<td>LC (500)</td>
</tr>
<tr>
<td>Year-end exchange rate</td>
<td>× 0.45</td>
<td>× 0.02</td>
</tr>
<tr>
<td>Financing cash flows based on year-end</td>
<td>USD 124</td>
<td>USD (10)</td>
</tr>
<tr>
<td>Financing cash flows reported in the statement of cash flows</td>
<td>113</td>
<td>(20)</td>
</tr>
<tr>
<td>Effect from financing activities during the year</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td><strong>Effect of exchange rate changes on cash</strong></td>
<td>USD 9</td>
<td>USD (5)</td>
</tr>
</tbody>
</table>

(a) This amount includes the effect of rounding.

### 9.7 Other Disclosure Considerations

Entities should also consider the foreign currency presentation and disclosure requirements in other ASC topics besides ASC 830 and, if applicable, those in SEC guidance.
9.7.1 SEC Considerations

The SEC staff has historically encouraged registrants to provide supplemental disclosures about how the reporting entity is affected by foreign operations and foreign currencies. For instance, in FRR 6 (codified in Section 501.09 of the Codification of Financial Reporting Policies), the staff gave several examples of the types of disclosures registrants should consider including in their MD&A (although the staff did not specify the preferred nature and location of such disclosures). These supplemental disclosures include:

- “[I]nformation enabling an evaluation of the amounts and certainty of cash flows from operations and a registrant’s ability to generate adequate amounts of cash to meet its need for cash (liquidity) as well as an assessment of the impact of events that have had, or may have, a material effect on trends of operating results.”
- “[D]isplay of net investments by major functional currency.”
- “[A]nalysis of the translation component of equity (either by significant functional currency or by geographical areas used for segment disclosure purposes).”
- “[F]unctional currencies used to measure significant foreign operations or the degree of exposure to exchange rate risks (which exists for all companies engaged in foreign operations, regardless of their functional currencies), in order to enable investors to assess the impact of exchange rate changes on the reporting entity.”

In addition, the staff cited two examples of instances in which registrants should consider providing additional disclosures:

1. When there is an “indication that all or some of [a foreign operation’s] cash flows are generally not available to meet the company’s other short-term needs for cash.” Such disclosures should be disaggregated enough to “meaningfully address liquidity and capital resource considerations,” and entities should especially consider disclosing the nature of their intra-entity financing in such situations.
2. When the reporting entity has “significant foreign operations in highly inflationary economies.”

Further, the SEC staff has indicated¹ that, when providing quantitative disclosures regarding foreign currency adjustments, registrants should:

- “[R]eview [MD&A] and the notes to financial statements to ensure that disclosures are sufficient to inform investors of the nature and extent of the currency risks to which the registrant is exposed and to explain the effects of changes in exchange rates on its financial statements.”
- Describe in their MD&A “any material effects of changes in currency exchange rates on reported revenues, costs, and business practices and plans.”
- Identify “the currencies of the environments in which material business operations are conducted when exposures are material.”
- “[Q]uantify the extent to which material trends in amounts are attributable to changes in the value of the reporting currency relative to the functional currency of the underlying operations [and analyze] any materially different trends in operations or liquidity that would be apparent if reported in the functional currency.”
- Identify, to the extent they are material, “ unhedged monetary assets, liabilities or commitments denominated in currencies other than the operation’s functional currency, and strategies for management of currency risk.”

¹ Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, Section II.J.
In assessing whether it needs to provide disaggregated financial information about its foreign operations in MD&A, a registrant should take into account more than just the percentage of consolidated revenues, net income, or assets contributed by foreign operations. The registrant also should consider how the foreign operations might affect the consolidated entity’s liquidity. For example, a foreign operation that holds significant liquid assets may be exposed to exchange-rate fluctuations or restrictions that could affect the registrant’s overall liquidity.

### 9.7.2 Non-GAAP Measures

Constant currency is a method used to eliminate the effects of exchange rate fluctuations of international operations in a registrant’s determination of financial performance. For example, when presenting its MD&A, a registrant with material operations in various countries should disclose the impact of material exchange rates. To do so, the registrant may use a constant exchange rate between periods for translation, which would remove the effect of fluctuations in foreign exchange rates.

The presentation of financial results in a constant currency is considered a non-GAAP measure.

<table>
<thead>
<tr>
<th>C&amp;DIs — Non-GAAP Financial Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Question 104.06</strong></td>
</tr>
<tr>
<td><strong>Question:</strong> Company X has operations in various foreign countries where the local currency is used to prepare the financial statements which are translated into the reporting currency under the applicable accounting standards. In preparing its MD&amp;A, Company X will explain the reasons for changes in various financial statement captions. A portion of these changes will be attributable to changes in exchange rates between periods used for translation. Company X wants to isolate the effect of exchange rate differences and will present financial information in a constant currency — e.g., assume a constant exchange rate between periods for translation. Would such a presentation be considered a non-GAAP measure under Regulation G and Item 10(e) of Regulation S-K?</td>
</tr>
<tr>
<td><strong>Answer:</strong> Yes. Company X may comply with the reconciliation requirements of Regulation G and Item 10(e) by presenting the historical amounts and the amounts in constant currency and describing the process for calculating the constant currency amounts and the basis of presentation. [Jan. 11, 2010]</td>
</tr>
</tbody>
</table>

Since constant-currency amounts are non-GAAP measures, the registrant should include the appropriate non-GAAP disclosures to isolate the effects of the exchange rate differences for (1) the historical amounts and (2) the amounts in constant currency. The disclosure of the non-GAAP measure should describe both the basis of presentation and how the constant-currency amounts were computed. Note that if a registrant only discloses the impact of exchange rates as part of its explanation of the period-to-period fluctuation between two GAAP amounts, such disclosure would not constitute a non-GAAP measure (e.g., foreign currency fluctuations resulted in $XX of the change in net revenue).

For more information about non-GAAP measures, see Deloitte’s *A Roadmap to Non-GAAP Financial Measures*. 

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9.7.3 Risks and Uncertainties

ASC 275-10

50-18 Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph 275-10-50-16. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one of the following categories:

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this Subtopic, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.

b. Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. Concentrations in the market or geographic area in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this Subtopic, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

50-19 Concentrations of financial instruments, and other concentrations not described in the preceding paragraph, are not addressed in this Subtopic. However, these other concentrations may be required to be disclosed pursuant to other Topics, such as Subtopic 825-10.

50-20 Disclosure of concentrations meeting the criteria of paragraph 275-10-50-16 shall include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor (see paragraph 275-10-50-18(c)) subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country (see paragraph 275-10-50-18(d)) that meet the criteria in paragraph 275-10-50-16, the following specific disclosures are required:

a. For labor subject to collective bargaining agreements, disclosure shall include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.

b. For operations located outside the entity's home country, disclosure shall include the carrying amounts of net assets and the geographic areas in which they are located.

This Subtopic does not, however, prohibit entities from also stating in disclosures of concentrations related to customers, grantors, or contributors or operations located outside the entity's home country that the entity does not expect that the business relationship will be lost or does not expect that the foreign operations will be disrupted if such is the case.

50-21 Adequate information about some concentrations may already be presented in other parts of the financial statements. For example, adequate information about assets or operations located outside the entity's home country may be included in disclosures made to comply with Subtopic 280-10. In accordance with the guidance in this Subtopic, such information need not be repeated.

As noted above, ASC 275 requires entities to provide disclosures about risks and uncertainties resulting from certain concentrations, including concentrations associated with foreign operations and therefore with exposure to foreign exchange risk.
In addition, SEC Regulation S-K, Item 303, requires SEC registrants to disclose in their MD&A any known trends, events, or uncertainties that are reasonably likely to have a material effect on their liquidity, capital resources, or results of operations.

The SEC staff has also historically provided informal guidance for registrants with foreign operations that may be subject to material risks and uncertainties, such as political risks, currency risks, and business climate and taxation risks. The staff has reminded registrants that the effects on their consolidated operations of an adverse event related to these risks may be disproportionate to the size of their foreign operations. Therefore, the staff has historically encouraged registrants to discuss in their MD&A any trends, risks, and uncertainties related to their operations in individual countries or geographic areas and to supplement such disclosures with disaggregated financial information about those operations.

In addition, SEC Regulation S-K, Items 503(c) and 305, require registrants to disclose risks, including risk factors and market risk. The SEC staff has emphasized that registrants should present tailored risk factors in their filings and avoid using boilerplate language. Registrants should consider whether to provide more specific discussion and enhanced explanations of how the risks could materially affect their business. This discussion may be supplemented with quantitative information that puts the risks in context.

**United Kingdom’s Brexit Vote**

Given the significant integration that has historically existed between the UK and EU economies, it is possible that the UK’s decision to exit the EU (often referred to as “Brexit”) may affect a registrant’s operations in the UK, the EU, or both. Although some uncertainty has been observed in the financial markets in response to the Brexit vote, it still may take several years for the effects of Britain’s exit from the EU to be fully negotiated and understood. During this period, registrants should consider establishing a process to monitor key developments and consider whether it would be appropriate to provide any early-warning disclosures to explain the possible material future favorable or unfavorable effects on an entity’s operations. Early-warning disclosures may give investors insight into (1) when charges may be incurred in the future; (2) whether a charge is related to contingencies, restructuring activities, impairment of goodwill or other long-lived assets, or the settlement of uncertain tax positions; (3) when revenue growth or profit margins may not be sustainable because of underlying economic conditions; or (4) when the registrant will be unable to comply with debt covenants. Accordingly, such disclosures may alert investors to the underlying conditions and risks that the entity faces before a material charge or decline in performance is reported.

Consequently, if a registrant (1) has foreign operations in the UK or the EU or (2) is otherwise exposed to business or financial risks resulting from Britain’s decision to exit the EU, and either exposure is reasonably likely to have a material effect on the registrant’s liquidity, capital resources, or results of operations, the registrant should consider providing enhanced disclosures about the following:

- The extent of the registrant’s operations in the affected region(s) (e.g., percentage of sales generated from the region), possibly supplemented with disaggregated financial information about those operations.
- The extent of the registrant’s material investments in entities within the region.
Chapter 9 — Presentation and Disclosure

- How the recent vote may affect the registrant's operations in the affected region(s) and, ultimately, its liquidity, capital resources, or results of operations.
  - Any of the registrant's other business or financial risks related to the affected region(s) (e.g., reliance on significant vendors or customers from the region(s)) and how such risks could affect the registrant's liquidity, capital resources, or results of operations.
  - Any of the registrant's business plans to respond to the circumstances in the affected region.
- Any potential material effects on the registrant's hedge accounting and any potential impairments that may be caused by volatility in exchange rates.

For more information about financial reporting implications related to the Brexit vote, see Deloitte’s March 31, 2017, Financial Reporting Alert.
Chapter 10 — Key Differences Between U.S. GAAP and IFRSs — Foreign Currency

10.1 Chapter Overview
The primary sources of guidance on accounting for foreign currency transactions and translations are ASC 830 under U.S. GAAP and IAS 21 and IAS 29 under IFRSs. Throughout this chapter, terminology applicable to both U.S. GAAP and IFRSs is used, depending on the applicable guidance (e.g., “foreign entity” in U.S. GAAP versus “foreign operation” in IFRSs).

The tables below summarize, for currently effective guidance, commonly encountered differences between the accounting for foreign currency transactions and translations under U.S. GAAP and that under IFRSs. Each table is followed by an explanation of the noted difference.

10.2 Functional Currency
10.2.1 Determination of the Functional Currency

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is no hierarchy of factors for entities to consider in determining the functional currency</td>
<td>There is a hierarchy of factors for entities to consider in determining the functional currency</td>
</tr>
</tbody>
</table>

The ASC master glossary under U.S. GAAP and IAS 21 under IFRSs both define “functional currency” as “the currency of the primary economic environment in which an entity operates.” In addition, both ASC 830-10-45-2 and paragraph 9 of IAS 21 specify that this currency is normally one in which the entity primarily generates and expends cash. However, a reporting entity's determination of the functional currency under U.S. GAAP may differ from that under IFRSs because certain economic factors are weighted more heavily under IFRSs.

Under U.S. GAAP, ASC 830-10-55-5 lists salient economic factors for entities to consider both individually and collectively when determining the functional currency. Such factors include, but are not limited to, the following indicators: cash flows, sales price, sales market, expense, financing, and intra-entity transactions and arrangements. However, an entity does not need to consider such factors as a hierarchy; rather, ASC 830-10-55-4 indicates that “[m]anagement is in the best position to . . . weigh their relative importance in determining the functional currency.” See Chapter 2 for additional information.

Under IFRSs, IAS 21 establishes a hierarchy of factors for entities to consider when determining the functional currency. Paragraph 9 of IAS 21 states that the two primary factors to consider are (1) the currency that mainly influences the entity's pricing of goods and services and (2) the currency that mainly influences the costs of providing goods or services. Paragraphs 10 and 11 of IAS 21 specify the secondary factors.

Currently effective guidance refers to guidance in effect for annual reporting periods beginning on January 1, 2017, and excludes guidance available for early adoption.
10.2.2 Translations When There Is a Change in Functional Currency

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td>The effect of a change in functional currency that is unrelated to a highly inflationary economy depends on whether the change is from the reporting currency to a foreign currency or vice versa. A change from the reporting currency to a foreign currency is accounted for prospectively from the date of the change. By contrast, a change from a foreign currency to the reporting currency is accounted for on the basis of the translated amounts at the end of the previous period.</td>
<td>The effect of a change in functional currency that is unrelated to a hyperinflationary economy is accounted for prospectively from the date of the change.</td>
</tr>
</tbody>
</table>

For changes in the functional currency that are unrelated to an economy’s becoming or ceasing to be highly inflationary (hyperinflationary), the accounting for a change in the functional currency under U.S. GAAP differs from that under IFRSs, which may result in differing cost bases for nonmonetary items after a change in the functional currency.

Under U.S. GAAP, ASC 830 indicates that the accounting for a change in functional currency depends on whether the change is from the reporting currency to a foreign currency or vice versa:

- For a change from the reporting currency to a foreign currency, ASC 830-10-45-9 requires that an entity translate the nonmonetary assets, as of the date of the change, into the new functional currency at the current exchange rate. The net effect of those translation adjustments on the accounting bases of the respective nonmonetary assets is recognized as a CTA through OCI.
- For a change from a foreign currency to the reporting currency, ASC 830-10-45-10 requires that the new cost bases for nonmonetary assets held in the period of change be the translated amounts at the end of the previous period.

The CTA associated with prior periods is not removed from equity until the CTA derecognition criteria are met. See Section 2.4 and Example 5-13 for additional information.

Like U.S. GAAP, IFRSs specify that the CTA associated with periods before the date of change is not removed from equity until the CTA derecognition criteria are met. However, under IFRSs, paragraph 37 of IAS 21 requires that a change in the functional currency be accounted for prospectively and states that “an entity translates all items into the new functional currency using the exchange rate at the date of the change.” For nonmonetary items, an entity treats the “resulting translated amounts” as the new cost bases for those items (i.e., their historical cost going forward).

Accordingly, for changes in the functional currency from a foreign currency to the reporting currency, the accounting under IFRSs will differ from that under U.S. GAAP. Under U.S. GAAP, the cost base of nonmonetary assets will be based on the translated amount at the end of the previous period. Under IFRSs, however, the translated amount will be based on the exchange rate in effect as of the date of the change. By contrast, a change in the functional currency from the reporting currency to a foreign currency would result in the determination of the cost bases of nonmonetary assets on the basis of the current exchange rate in effect as of the date of the change under both standards.
Connecting the Dots
Under IFRSs, a change in functional currency should be recognized as of the date it is determined that there has been a change in the underlying events and circumstances relevant to the reporting entity that justifies a change in the functional currency. This could occur on any date during the year. However, for convenience, and as a practical matter, there is a practice of using a date at the beginning of the most recent period (annual or interim, as the case might be).

In practice, changes in functional currency are uncommon. Any change in functional currency may receive regulatory scrutiny regarding the specific events causing the change.

10.3 Remeasuring Foreign Currency Balances in the Functional Currency

10.3.1 Transaction Gains and Losses Related to AFS Debt Securities

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction gains or losses related to AFS debt securities are reported in OCI</td>
<td>Transaction gains or losses related to AFS debt securities are reported in earnings</td>
</tr>
</tbody>
</table>

U.S. GAAP may differ from IFRSs regarding the timing of recognition through earnings of transaction gains and losses related to AFS debt securities.

Under U.S. GAAP, ASC 320-10-35-36 indicates that transaction gains and losses related to AFS debt securities should be considered part of the overall change in fair value of the investment and should therefore be reported in OCI. Under IFRSs, paragraph AG83 of IAS 39 and paragraph 28 of IAS 21 require entities to segregate the foreign currency impact of the change in fair value of an AFS debt security and report these gains and losses in earnings.

10.3.2 Recognition of Deferred Taxes for Temporary Differences Related to Nonmonetary Assets and Liabilities From Changes in the Exchange Rate

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td>No deferred tax is recognized for temporary differences caused by changes in the exchange rate for nonmonetary assets and liabilities when the local currency amount is remeasured to the functional currency</td>
<td>Deferred tax is recognized for temporary differences caused by changes in the exchange rate for nonmonetary assets and liabilities when the local currency amount is remeasured to the functional currency</td>
</tr>
</tbody>
</table>

When the currency for tax purposes (i.e., the local currency) differs from the functional currency for accounting purposes, temporary differences associated with nonmonetary assets and liabilities resulting from changes in exchange rates are reflected differently under U.S. GAAP than they are under IFRSs.

Under U.S. GAAP, ASC 740-10-25-3(f) prohibits “recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under [ASC] 830-10, are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes.” In other words, deferred taxes are not recorded for basis differences related to nonmonetary assets and liabilities that result from changes in exchange rates.
Although this basis difference technically meets the definition of a temporary difference under ASC 740, the FASB concluded that accounting for it as a temporary difference would result in the recognition of deferred taxes for exchange gains and losses that are not recognized in the income statement under ASC 830. For this reason, the FASB decided to prohibit recognition of the deferred tax consequences for those differences. For additional discussion, see Chapter 8 as well as Section 12.02 of Deloitte’s A Roadmap to Accounting for Income Taxes.

Under IFRSs, deferred taxes on such changes in exchange rates are recognized. Paragraph 41 of IAS 12 states:

> The non-monetary assets and liabilities of an entity are measured in its functional currency (see IAS 21). If the entity’s taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss (see paragraph 58).

### 10.4 Translations Into the Reporting Currency

#### 10.4.1 Translation Process for Multitiered Organizations

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use of the step-by-step method is generally required</td>
<td>Allow for a policy choice between the step-by-step method and the direct method</td>
</tr>
</tbody>
</table>

While neither U.S. GAAP nor IFRSs contain explicit guidance on the mechanics of the consolidation process for multitiered organizations, differing interpretations have emerged regarding the determination of the CTA. The application of the differing methods for translating multitiered organizations may affect the determination of the CTA and subsequent assessment.

Two of the approaches that have emerged for translating the financial results of multitiered organizations are as follows:

- **Step-by-step method** — Under this method, the financial results of each foreign entity (operation) would first be translated into the functional currency of its intermediate parent, which would in turn be translated into the functional currency of its intermediate parent (if any). Ultimately, the foreign entity (operation) would be translated into the reporting (presentation) currency of the consolidated reporting entity.

- **Direct method** — Under this method, the financial results of a foreign entity (operation) are directly translated into the reporting (presentation) currency of the consolidated reporting entity.

Under U.S. GAAP, multitiered organizations typically apply the step-by-step method when applying the translation and consolidation guidance. (However, this issue is not specifically addressed in ASC 810 or ASC 830.)

Under IFRSs, while no explicit guidance exists, in practice entities historically have been permitted to elect a policy of using either the step-by-step method or the direct method for foreign operations within

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2 The November 2011 SEC staff paper also identified this as a potential difference between U.S. GAAP and IFRSs, stating, in part, “Translation of entities with multi-level organizational structures — U.S. GAAP respects the ownership structure of a complex entity with differing functional currencies for purposes of performing the translation accounting to prepare the consolidated financial statements in the reporting currency. Consolidation occurs step-by-step. IFRS provides no corresponding guidance. An entity may perform “direct” translation of each subsidiary into the reporting currency, ignoring any intervening subsidiaries (even if their functional currency is different). The choice of consolidation method employed could affect the cumulative translation adjustments deferred within equity at intermediate levels and can therefore also affect the recycling of such exchange rate differences upon disposal of an intermediate foreign operation.”
multitiered organizations. Paragraph 17 of IFRIC 16 acknowledges the use of either approach under IFRSs.

### 10.4.2 Parent and Investee With Different Fiscal-Year-End Dates — Differences in Exchange Rates

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity may elect a policy of either disclosing, or both disclosing and recognizing, material intervening events</td>
<td>Adjustments for significant post-balance-sheet changes in exchange rates, up to the date of the consolidated financial statements, should be made</td>
</tr>
</tbody>
</table>

When consolidating a subsidiary or accounting for an equity method investee, a reporting entity must consider whether the subsidiary or equity method investee has a reporting lag. The implications of a reporting lag may be viewed differently under U.S. GAAP than they are under IFRSs. Further, in situations in which a reporting lag is permitted, if there is a significant change in exchange rates between the reporting date of the subsidiary or equity method investee that is a foreign entity (or foreign operation) and the reporting date of the consolidated group, an entity may use a different exchange rate to translate the foreign currency statements under U.S. GAAP than it does under IFRSs, depending on the entity’s policy for material intervening events under U.S. GAAP.

Under U.S. GAAP, ASC 810 acknowledges that as long as the fiscal-year-end dates of the parent and subsidiary are not more than three months apart, it generally would be acceptable for the parent to use the subsidiary’s financial statements for its fiscal period. This provision is also consistent with the treatment of equity method investees in practice.

When such a reporting lag exists, a reporting entity must apply the guidance in ASC 830-30 and use the exchange rate as of the foreign entity's balance sheet date to translate the financial statements of the foreign entity. However, if the exchange rate fluctuates between the foreign entity's balance sheet date and the reporting entity's balance sheet date (i.e., an intervening event), the reporting entity may elect a policy of either disclosing all material intervening events or both disclosing and recognizing them. Either policy is acceptable and should be consistently applied to all material intervening events that meet the recognition requirements in U.S. GAAP. For more information, see Section 3.3.1 of this Roadmap as well as Section 11.1.3 of Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.

Under IFRSs, IFRS 10 and IAS 28 note that a reporting entity is required to prepare financial statements of the subsidiary or equity method investee for the date of the reporting entity's financial statements unless it is impractical to do so. If it is impractical, the difference can be no greater than three months and adjustments should be made for significant transactions.

Accordingly, because IFRS 10 for consolidated subsidiaries, IAS 28 for equity method investees, and IAS 21 require a reporting entity to make adjustments for significant transactions or events that occur between the date of a subsidiary's financial statements and the date of the reporting entity's financial statements, a significant fluctuation in exchange rates up to the reporting entity's balance sheet date would be recognized.
10.5 Release of CTA Upon Disposals or Sales of Foreign Equity Method Investees (Investments in Associates)

10.5.1 Identifying What Qualifies as a Partial Disposal That May Result in a Reclassification or Reattribution of the CTA

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Only changes in a parent’s ownership interest (equity investments in a foreign entity) may be treated as partial disposals that result in a reclassification or reattribution of CTA.</td>
<td>Do not distinguish between partial disposals of investments in and those within a foreign operation.</td>
</tr>
<tr>
<td>Accordingly, the sale or liquidation of the net assets within a foreign entity would not result in a release or reattribution of CTA (unless it results in a complete or substantially complete liquidation of the foreign entity).</td>
<td>Accordingly, an entity can elect either the proportionate or absolute reduction approach as an accounting policy and, if applicable, can choose how the absolute reduction approach is applied.</td>
</tr>
</tbody>
</table>

Under both U.S. GAAP and IFRSs, a partial sale of a foreign entity (operation) may sometimes result in a (1) pro rata release of CTAs into earnings for equity method investments for which significant influence is not lost or (2) reattribution of CTAs to NCI for consolidated entities for which control is not lost. However, U.S. GAAP may differ from IFRSs regarding the determination of the type of partial disposal that may affect the CTA balance.

For example, a reduction in an investment may occur in the following scenarios:

- **Reduction in equity ownership interest** — An investor may reduce its ownership interest and percentage by selling equity ownership in the investee.

- **Reduction in absolute interest** — There are various other transactions that do not affect an investor’s percentage equity ownership but that could potentially reduce its ownership interest in the investee through an absolute reduction (e.g., a pro rata repayment of capital by the foreign operation to all investors or the repayment of a loan or redemption of nonequity shares that form part of the net investment in the investee).

Under U.S. GAAP, ASC 830-30-40-2 and 40-3 indicate that only a reduction in the equity ownership interest in a foreign entity may be treated as a partial disposal that results in a reclassification or reattribution of the CTA. Accordingly, a reduction in the absolute interest through changes in an investment within a foreign entity (e.g., reduction in the net assets or repayment of long-term advances) would not be viewed as akin to a reduction in equity ownership interest (see Example 5-16). Therefore, for scenarios involving reductions in the absolute interest, with no corresponding reduction in the equity ownership interest, ASC 830-30-40-3 would be applicable and reclassification of the CTA would only be permitted if the sale or disposal of the investment within the foreign entity resulted in the complete or substantially complete liquidation of the foreign entity.

By contrast, IFRSs do not specifically distinguish between an investment in and an investment within a foreign operation. Paragraph 48D of IAS 21 defines a partial disposal of an entity’s interest in a foreign operation as “any reduction in an entity’s ownership interest in a foreign operation, except those reductions in paragraph 48A [of IAS 21] that are accounted for as disposals.” Because IAS 21 does not provide any further guidance on what is meant by “any reduction in an entity’s ownership interest in a foreign operation,” two approaches have emerged: (1) the proportionate reduction approach and (2) the absolute reduction approach.
Under the proportionate reduction approach, a transaction that does not reduce the investor's equity ownership of a foreign entity will generally not result in the reclassification or reattribution of the CTA (this effect is similar to that under U.S. GAAP). However, under the absolute reduction approach, a transaction that reduces the absolute or relative ownership in the foreign entity (e.g., via a sale of net assets or repayment of long-term loans) would trigger such reclassification or reattribution.

Accordingly, under IAS 21, an entity is required to elect either the proportionate or absolute reduction approach as an accounting policy and, if applicable, can choose how the absolute reduction approach is applied. For additional details on the approaches, see 6.4.4 of Chapter A19 of Deloitte's 2017 iGAAP Book, which is included in this Roadmap in Appendix C.

Thus, when an entity liquidates a portion of its investment or has other ownership dilution events, the amount and timing of CTA reclassification or reattribution under IFRSs could differ from that under U.S. GAAP, depending on the accounting policy elected under IFRSs.

### 10.5.2 CTA Associated With Retained Interest When Significant Influence Is Lost

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<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRSs</th>
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<tbody>
<tr>
<td>Upon a loss of significant influence, the proportionate amount of the CTA is reclassified from equity to earnings; the remaining CTA balance is reclassified against the carrying value of the retained interest</td>
<td>Upon a loss of significant influence, the entire CTA associated with the investment is reclassified from equity to earnings, irrespective of whether interest is retained</td>
</tr>
</tbody>
</table>

Under both U.S. GAAP and IFRSs, a partial sale of an entity's interest in an equity method investment (associate) that is a foreign entity (operation), when the entity retains significant influence over the investment, would trigger a pro rata recognition of accumulated CTA amounts related to that investment. However, if such a sale causes the entity to lose significant influence, U.S. GAAP may differ from IFRSs regarding the characterization or timing of the earnings impact associated with the remaining interest's pro rata portion of the CTA.

Under U.S. GAAP, upon a loss of significant influence, ASC 323 and ASC 830 require that the proportionate amount of CTA associated with the remaining interest become part of the carrying value of the retained interest, provided that the carrying value is not reduced below zero. Under ASC 323-10-35-39, if the carrying value would be reduced below zero, the carrying value would be adjusted to zero, with the remaining balance recognized through earnings. See Section 5.4.1 for additional discussion.

Under IFRSs, upon a loss of significant influence, paragraph 48A of IAS 21 requires that the entire amount of accumulated CTA related to that investment be reclassified into earnings as if the whole investment was disposed of, irrespective of whether interest is retained.
Changing Lanes

In a manner consistent with the discussion in Section 5.4.1, upon adopting ASU 2016-01, entities will no longer be permitted to account for investments in certain equity securities that are within the standard’s scope at cost. Instead, such securities will generally be accounted for at fair value, with changes in fair value recognized in net income. An exception to this requirement is that the ASU permits entities to measure certain qualifying equity securities without a readily determinable fair value at cost minus impairment, adjusted for changes in qualifying observable prices.

As a result, while there would be no change to the requirement in ASC 323 and ASC 830 to treat the remaining CTA as an adjustment to the carrying value of the investment upon a loss of significant influence, for instruments that an entity would be required to measure at fair value, the entire amount of CTA would effectively be released through earnings upon a loss of significant influence. Such accounting would be consistent with that under IFRSs from the perspective of the timing of the earnings impact. However, because of differences in the characterization of the CTA associated with the retained interest, differences would remain regarding whether such an earnings impact reflects a realized or unrealized gain or loss. Further, differences would also remain between IFRSs and U.S. GAAP for instruments that under the ASU are measured at cost minus impairment, adjusted for changes in qualifying observable prices.

10.6 Impact of CTA on the Measurement of Impairment Losses of Foreign Investees Held for Disposal

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<th>U.S. GAAP</th>
<th>IFRSs</th>
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<tr>
<td>In certain circumstances, entities are required to include related CTA in the carrying amount of an investment in a foreign entity that is being evaluated for impairment</td>
<td>Entities are not permitted to include related CTA in the carrying amount of an investment in a foreign operation that is being evaluated for impairment</td>
</tr>
</tbody>
</table>

U.S. GAAP may differ from IFRSs regarding the measurement of impairment loss for foreign entities (operations) that have a related CTA.

Under U.S. GAAP, ASC 830 requires entities to include any related CTA in the carrying amount of an investment in a foreign entity (1) that is classified as held for disposal, (2) for which a clear plan to sell and liquidate the investment in a manner that would trigger the CTA release has been established, and (3) that is being evaluated for impairment. See Section 5.5 for further discussion.

Under IFRSs, IAS 21 does not permit entities to include the related CTA balance in the carrying amount of the foreign operation investment when measuring the impairment loss. Paragraphs BC37 and BC38 of IFRS 5 further address this issue.

10.7 Highly Inflationary (Hyperinflationary) Economies

Highly inflationary (or hyperinflationary) economies are not common in today’s global environment. For entities that operate in such an economy, there are a number of differences between IFRSs and U.S. GAAP with respect to both the identification of whether the economy is highly inflationary (hyperinflationary) and how an entity adjusts for the effects of the inflation and subsequently ceasing to be highly inflationary (hyperinflationary).

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3 In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. For public business entities, the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. For additional information on ASU 2016-01, see Deloitte’s January 12, 2016, Heads Up.
10.7.1 Identifying Whether an Economy Is Highly Inflationary (Hyperinflationary)

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<th>U.S. GAAP</th>
<th>IFRSs</th>
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<tr>
<td>There is a prescribed criterion for determining whether an economy is highly inflationary (i.e., the absolute rate of inflation) that, when met, results in highly inflationary accounting “in all instances”</td>
<td>There are no prescribed criteria that result in automatic hyperinflationary treatment; rather, there are several judgment-based characteristics related to determining whether an economy is hyperinflationary</td>
</tr>
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An entity’s conclusion regarding whether an economy is highly inflationary under U.S. GAAP could, in theory, differ from that under IFRSs. However, U.S. GAAP’s “cumulative inflation of approximately 100 percent or more” requirement typically would be met under both sets of standards. Therefore, in practice, economies that are considered hyperinflationary under IFRSs are not typically expected to differ from those that are considered highly inflationary under U.S. GAAP, and vice versa.

Under U.S. GAAP, ASC 830-10-45-11 provides one criterion for identifying a highly inflationary economy: “cumulative inflation of approximately 100 percent or more over a 3-year period.” ASC 830-10-45-12 requires that the assessment of highly inflationary begins with the determination of the inflation rate, noting that when the cumulative inflation rate is less than 100 percent, “inflation rate trends (increasing or decreasing) and other pertinent economic factors should be considered to determine whether such information suggests that classification of the economy as highly inflationary is appropriate.” ASC 830-10-45-13 further notes that “[i]n some instances, the trend of inflation might be as important as the absolute rate” and that an entity will need to use judgment in determining whether an economy is highly inflationary when the cumulative inflation rate is approaching 100 percent. Accordingly, an entity may use judgment when an economy’s inflation rate is approaching 100 percent, but once the cumulative rate reaches 100 percent, the economy must be considered highly inflationary “in all instances.”

Under IFRSs, paragraph 3 of IAS 29 provides several judgment-based indicators of a hyperinflationary economy rather than providing “an absolute rate at which hyperinflation is deemed to arise.” These indicators include whether the general population “prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency” and whether “the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency.” In other words, under IFRSs, an economy is not automatically considered hyperinflationary once the cumulative inflation rate reaches 100 percent; rather, an entity may use judgment in determining whether the economy is hyperinflationary.

10.7.2 Commencing Accounting for Highly Inflationary (Hyperinflationary) Economies

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<th>U.S. GAAP</th>
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<tr>
<td>Commence the requisite accounting on the first day of the next reporting period in which it becomes subject to a highly inflationary economy</td>
<td>Commence the requisite accounting from the beginning of the reporting period in which it becomes subject to a hyperinflationary economy</td>
</tr>
</tbody>
</table>
IFRSs differ from U.S. GAAP regarding the timing of when an entity commences accounting for highly inflationary (hyperinflationary) economies. Under U.S. GAAP, once an entity identifies that it is subject to a highly inflationary economy, it should commence the requisite accounting on the first day of the next reporting period (see Section 7.3). Comparatively, under IFRSs, once an entity identifies that it is subject to a hyperinflationary economy, IAS 29 requires that an entity commence the requisite accounting from the beginning of the reporting period.

10.7.3 Translations of Foreign Entities Whose Functional Currency Is the Currency of a Highly Inflationary (Hyperinflationary) Economy

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<th>U.S. GAAP</th>
<th>IFRSs</th>
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<tbody>
<tr>
<td>Restatement of the foreign entity's financial statements is not permitted before translation. That is, the effects of a highly inflationary economy are accounted for prospectively. Further, the financial statements of the foreign entity are remeasured for consolidation purposes as if the immediate parent's reporting currency were its functional currency.</td>
<td>Restatement of the foreign operation's financial statements is required before translation (purchasing power adjustments are made retrospectively). That is, the effects of a hyperinflationary economy are accounted for retrospectively. Further, the financial statements of the foreign operation are translated into the presentation currency by using the closing rate as of the balance sheet date.</td>
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</table>

IFRSs differ from U.S. GAAP regarding how and when an entity adjusts for the effects of high inflation. These differences between IFRSs and U.S. GAAP are significant for consolidated financial statements that include a foreign entity (operation) whose functional currency is that of a highly inflationary (hyperinflationary) economy.

Under U.S. GAAP, ASC 830 does not permit entities in highly inflationary economies to restate financial statements for purchasing power adjustments (i.e., prospective treatment is required). ASC 830-10-45-11 requires that the financial statements of a foreign entity in a highly inflationary economy be “remeasured as if the functional currency were the reporting currency.” In other words, translated balances at the end of the period in which an economy becomes highly inflationary become the new accounting basis, and the foreign entity uses the functional currency of its immediate parent as its own functional currency going forward. (Note that ASC 255-10-50-1 permits, but does not require, an entity “to disclose supplementary information on the effects of changing prices.”)

Under IFRSs, IAS 29 and paragraphs 42 and 43 of IAS 21 require that a foreign operation's financial statements, in terms of the measuring unit as of the balance sheet date, be restated before they are translated into the presentation currency. In other words, IFRSs require entities to apply purchasing power adjustments (i.e., price-level adjustments) to all financial statement balances before translation (retrospective). Paragraph 42(a) of IAS 21 also requires that all amounts in the financial statements of an entity whose functional currency is hyperinflationary be translated into the presentation currency by using the closing rate as of the most recent balance sheet date. Further, under paragraph 42(b) of IAS 21, if the presentation currency is the currency of a nonhyperinflationary economy, all comparative amounts must be “those that were presented as current year amounts in the relevant prior year financial statements (i.e not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).”
10.7.4 Economies That Cease to Be Highly Inflationary (Hyperinflationary)

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<th>U.S. GAAP</th>
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<tr>
<td>The functional currency accounting bases for nonmonetary assets and liabilities are determined by translating the reporting currency amounts as of the date of change into the local currency at current exchange rates.</td>
<td>The functional currency accounting bases for nonmonetary assets and liabilities are the unit currency amount at the end of the previous reporting period.</td>
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</table>

When entities cease to have operations in highly inflationary (hyperinflationary) economies, the functional currency accounting bases for nonmonetary assets and liabilities under U.S. GAAP differ from those under IFRSs.

Under U.S. GAAP, ASC 830-10-45-15 states that when an economy ceases to be highly inflationary, an entity should translate the reporting currency amounts as of the date of change into the local currency at current exchange rates and should report those amounts as the new functional currency accounting bases for the nonmonetary assets and liabilities.

Under IFRSs, paragraph 43 of IAS 21 states that when an economy “ceases to be hyperinflationary and the entity no longer restates its financial statements in accordance with IAS 29, it shall use as the historical costs . . . the amounts restated to the price level at the date the entity ceased restating its financial statements.” Accordingly, and in a manner consistent with paragraph 38 of IAS 29, the new functional currency accounting bases for the nonmonetary assets and liabilities would be based on the unit currency amounts at the end of the previous reporting period.

10.8 Other Considerations

10.8.1 Reporting and Presentation Currencies

While the application of the guidance in U.S. GAAP on reporting currencies is substantially the same as that under IFRSs, ASC 830 does not address the translation of an entity’s financial statements from its reporting currency into a different presentation currency for convenience purposes (see ASC 830-10-15-7). The SEC staff presumes that U.S.-incorporated issuers use the USD as their reporting currency unless substantially all of the issuer’s operations are conducted in a single functional currency and that currency is used as the reporting currency (see the codification of AICPA International Practices Task Force highlights as of March 2003). However, the SEC staff effectively gives foreign private issuers a choice to select a reporting currency, although ASC 830 should be applied in the selection of the functional currency (see the SEC’s November 1, 2004, “International Reporting and Disclosure Issues in the Division of Corporation Finance” and SEC Regulations S-X, Rule 3-20(b)). SEC rules permit, but do not require or encourage, foreign issuers to present a convenience translation for the most recent fiscal year and any subsequent interim period, if the reporting currency is not the U.S. dollar. SEC Regulation S-X, Rule 3-20(b), specifies that if such a convenience translation is presented, the translation should be presented by “using the exchange rate as of the most recent balance sheet included in the filing, except that a rate as of the most recent practicable date shall be used if materially different.” Further, Section 6620.5 of the SEC Financial Reporting Manual notes that “[t]he rate used for the convenience translation should generally be the rate that the issuer would use if dividends were to be paid in U.S. dollars.”

Under IFRSs, paragraph 38 of IAS 21 permits an entity to present its financial statements in any currency or currencies. If the presentation currency differs from the functional currency, an entity must follow certain specified translation procedures under paragraphs 38–43 of IAS 21. However, paragraphs 57 and BC14 of IAS 21 indicate that an entity is not precluded from displaying supplementary information prepared by using different translation methods provided that such information is clearly identified to
distinguish it from information translated in accordance with IFRSs. In preparing the supplementary
information, entities may present the entire financial statements or selected portions depending on
the intended use of such information. If entities choose to provide any supplementary disclosures, they
must present them separately from the information required by IFRSs and translate them in accordance
with IAS 21.

10.8.2 Required Disclosures

IAS 21 and IAS 29 require more disclosures than ASC 830. However, SEC registrants are subject to
additional disclosure requirements. For example, SEC Regulation S-X, Rule 3-20, requires foreign private
issuers to provide additional disclosures. Because of these requirements, SEC registrants provide
substantially the same disclosures as they would under IFRSs.
Appendix A — SEC Staff Review Process and Sample SEC Comments: Foreign Currency

SEC Staff Review Process
The SEC’s Division of Corporation Finance (the “Division”) selectively reviews filings made under the Securities Act and the Exchange Act. In January 2009, the SEC staff issued an overview that explains its filing review and comment letter process. The overview aims to increase transparency in the review process and expresses the staff’s willingness to discuss issues with registrants. For example, the overview indicates that the “[staff] views the comment process as a dialogue with a company about its disclosure” and that a “company should not hesitate to request that the staff reconsider a comment it has issued or reconsider a staff member’s view of the company’s response to a comment at any point in the filing review process.”

The overview is divided into two main sections:

- **The filing review process** — This section explains that the Division comprises 11 offices staffed by experts in specialized industries, accounting, and disclosures. The section includes background on the different types of review (required and selective) and covers the comment process, indicating that much of the staff’s review process “involves evaluating the disclosure from a potential investor’s perspective and asking questions that an investor might ask when reading the document.” The section also addresses how to respond to staff comments and close a filing review.

- **The reconsideration process** — This section emphasizes that “staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a company and its legal, accounting, and other advisors.” In addressing a registrant’s potential request for the SEC staff to reconsider a staff member’s comment or view on the registrant’s response, the staff emphasizes that registrants do not have to “follow a formal protocol.” However, the staff explains where registrants should start and the steps involved in the normal course of the reconsideration process. The staff also specifies contact information for each office for both accounting and financial disclosure matters and legal and textual disclosure matters.

Registrants may involve the SEC’s Office of the Chief Accountant (OCA) during any stage of the review process. Unlike the Division’s role, which is to address matters related to the age, form, and content of registrants’ financial statements that are required to be filed, the OCA’s role is to address questions concerning a registrant’s application of GAAP. Guidance on consulting with the OCA is available on the SEC’s Web site.

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1 An overview of the legal, regulatory, and capital markets offices is also available on the SEC’s Web site.
A registrant that receives an SEC comment letter should generally respond within the time frame indicated in the letter. The registrant should continue to respond to any requests for more information until it receives a letter from the Division stating that the Division has no further comments. A registrant that does not receive a completion letter within a reasonable amount of time after submitting a response letter should call its SEC staff reviewer (named in the letter) to ask about the status of the review. If the review is complete, the registrant should request a completion letter.

To increase the transparency of the Division’s review process, comment letters and company responses to those letters are made public, via the SEC’s Web site, at least 20 business days after the Division has completed its review of a periodic or current report or declared a registration statement effective.

Foreign Currency Comment Letters
The SEC staff’s comments on quantitative disclosures related to foreign currency reflect published staff views2 on the topic, under which registrants should:

- “[R]eview management’s discussion and analysis and the notes to financial statements to ensure that disclosures are sufficient to inform investors of the nature and extent of the currency risks to which the registrant is exposed and to explain the effects of changes in exchange rates on its financial statements.”
- Describe in their MD&A “any material effects of changes in currency exchange rates on reported revenues, costs, and business practices and plans.”
- Identify “the currencies of the environments in which material business operations are conducted [when] exposures are material.”
- “[Q]uantify the extent to which material trends in amounts are attributable to changes in the value of the reporting currency relative to the functional currency of the underlying operations [and analyze] any materially different trends in operations or liquidity that would be apparent if reported in the functional currency.”

The extracts in this publication that reflect these topics have been reproduced from comments published on the SEC’s Web site that were issued between June 1, 2013, and June 30, 2016. In instances in which there were numerous comments on the same topics, only certain comments have been included. Dollar amounts and information identifying registrants or their businesses have been redacted from the comments.

For a discussion of SEC comment letters on additional topics, see the following Deloitte publications:


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2 Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, Section II.J
Examples of SEC Comments

Determination of Functional Currency

Although ASC 830 states that an entity’s functional currency is “a matter of fact,” sometimes it may not be clear what the functional currency is if, for instance, “a foreign entity conducts significant amounts of business in two or more currencies.” An entity may need to use significant judgment in determining the functional currency, depending on the nature of the foreign entity being evaluated. If a registrant conducts business in more than one currency, the SEC often may request additional information regarding the judgments an entity used in making this determination, particularly when other disclosures seem contradictory.

- You disclose that the U.S. dollar is your functional currency; however, we note that all of your current operations are outside of the U.S. Using the guidance in ASC 830-10-45 and ASC 830-10-55 please tell us how you determined your functional currency.
- Please refer to the following disclosure in the last paragraph on page [XX] under the risk factor “Fluctuations in Foreign Currency Exchange Rates Could Negatively Affect Our Profitability.”
  - “... we have substantial operations in [Country] and a significant portion of our premiums and investment income in [Country] is received in [LC]. Most claims and expenses associated with our operations in [Country] are also paid in [LC] and we primarily purchase [LC]-denominated assets to support [LC]-denominated policy liabilities.”
  You disclose herein, however, that [Country] is an exception to your use of the local currency as the functional currency and that “multiple functional currencies exist in [Country].” Tell us why the [LC] is not the functional currency for your [Country] operations and what you mean by “multiple functional currencies exist” in [Country]. In your response, tell us what you determined the functional currencies to be for your [Country] operations, and include an analysis supporting your determination under ASC 830-10-45 and ASC 830-10-55.
- Pursuant to ASC 830-10-45-2, please help us better understand how you determined that the U.S. dollar is the currency of the primary economic environment in which you operate and in which you primarily generate and expend cash. Please specifically address your consideration of ASC 830-10-55-3 through 55-5. We note that your disclosures on page [XX] indicate that you have not generated any revenues in the U.S. and that all of your long-lived assets are located in [Country].

Change in Functional Currency

Regardless of the underlying reason for a change in functional currency, the SEC has historically suggested that a registrant, although it is not required to do so under ASC 830, “should consider the need to disclose the nature and timing of the change, the actual and reasonably likely effects of the change, and economic facts and circumstances that led management to conclude that the change was appropriate.” In addition, the registrant should discuss in its MD&A the “effects of those underlying economic facts and circumstances on the registrant’s business.” When registrants fail to do so, the staff may issue comments requesting additional disclosures about the underlying reason for the change and the associated effects.

- As discussed on page [XX], we note that as a result of the Acquisition, you reevaluated your functional currency accounting conclusions. Due primarily to your new legal entity organization structure, global cash management and raw material sourcing strategies, you determined that the functional currency of certain subsidiaries operating outside of the United States is the local currency of the respective subsidiaries. For the Predecessor period, your reporting currency was the U.S. dollar as [Company] management determined that the U.S. dollar was the functional
currency of [the Company’s] legal entities and this functional currency was appropriate for the [the Company’s] organizational legal entity structure and the economic environment in which [the Company] operated during the period covered by the Predecessor consolidated and combined financial statements. With reference to ASC 830-10-45-3 through 45-6, please provide a thorough analysis that demonstrates the appropriateness of the functional currency of your subsidiaries in both the Successor and Predecessor periods.

- We note your disclosure that “effective February [XX, XXXX], [the Company’s] functional currency changed to the United States dollar.” Please explain to us the facts and circumstances that resulted in the change in functional currency, including your consideration of each factor outlined in ASC 830-10-55-5.

- We note your disclosure that “effective July [X, XXXX], the Company changed its functional currency to the U.S. dollar from the [LC].” Please tell us, and revise future filings to more fully explain, the specific facts and circumstances that resulted in this change, including your consideration of each factor outlined in ASC 830-10-55-5.

Disclosures in MD&A and Risk and Uncertainties

The foreign operations of many registrants may be subject to material risks and uncertainties that should be disclosed, including those related to the foreign jurisdiction’s political environment, its business climate, currency, and taxation. The effects on a registrant’s consolidated operations of an adverse event related to these risks may be disproportionate in relation to the size of the registrant’s foreign operations. Therefore, the registrant’s segment information or MD&A may need to describe the trends, risks, and uncertainties related to its operations in individual countries or geographic areas and possibly supplement such disclosures with disaggregated financial information about those operations.

A registrant’s assessment of whether it needs to provide disaggregated financial information about its foreign operations in its MD&A would need to take into account more than just the percentage of consolidated revenues, net income, or assets contributed by foreign operations. The registrant also should consider how the foreign operations might affect the consolidated entity’s liquidity. For example, a foreign operation that holds significant liquid assets may be exposed to exchange-rate fluctuations or restrictions that could affect the registrant’s overall liquidity.

The staff continues to ask registrants to provide early-warning disclosures to help financial statement users understand these items and how they potentially affect the financial statements. For additional information about early-warning disclosures, see the “Management’s Discussion and Analysis” section of Deloitte’s ninth edition of SEC Comment Letters — Including Industry Insights — What “Edgar” Told Us.

- We note your risk factor on page [XX] related to the value of the currencies in countries where you operate against the U.S. dollar and its effect on your financial results reported in U.S. dollar terms. As such, fluctuations in foreign exchange rates could affect your financial results reported in U.S. dollar terms without giving effect to any underlying change in your business or results of operations. Please fully expand your discussion of results of operations to separately quantify for each period presented the amount of the change in revenues and expenses that is due to foreign currency translations.

- With regards to any material foreign operations, please tell and disclose the following: . . .
  - Disclose any material foreign currency exchange differences during each period in accordance with ASC 830
We note you were able to achieve sales growth during fiscal 2015 despite $[XX] million of adverse impact from the effects of foreign exchange. Please tell us whether you also experienced an offsetting impact to cost of sales for such strengthened US dollar, as you indicate gross margin was also adversely impacted by foreign exchange and there appears to be no discussion of the impact to your total cost of sales. Additionally, tell us what consideration you gave to providing a constant currency disclosure to quantitatively illustrate the impact of changes in foreign currency rates between periods.

We note your disclosure that the weakening of the U.S. dollar against the [LC] contributed to the change in net sales and cost of sales for the year ended December [XX, XXXX] compared to the year ended December [XX, XXXX]. In addition, you also disclose that the strengthening of the U.S. dollar against the [LC] impacted other expenses, net for the year ended December [XX, XXXX] compared to the year ended December [XX, XXXX]. Please clearly explain the disclosure surrounding the foreign currency impact on your operations, specifically how the U.S. dollar strengthened and weakened against the [LC] within the same year.

We note that foreign currency exchange rates materially impacted your consolidated statements of income and consolidated statements of comprehensive income. Please expand your disclosure to provide the disclosures required by Item 305 of Regulation S-K, including a discussion of the specific foreign currency rate exposures that represent the primary risk of loss.

We note your disclosure which states $[XX] billion (of the total $[XX] billion reflected on your balance sheet) of cash, cash equivalents and marketable securities is held off-shore by foreign subsidiaries. We further note your charge relating to your [Country A] deconsolidation included $[XXX] million of cash held in [Country A]. In addition, we note your risk factor disclosure which states you maintain cash balances in a number of foreign countries with exchange and other controls including [Countries A–H]. In future filings, please expand your liquidity section to provide disclosure of the amounts and foreign jurisdictions where the majority of your cash, cash equivalents and marketable securities is located. In addition, provide separate disclosure of the amounts and locations of cash, cash equivalents and marketable securities held in foreign jurisdiction subject to exchange controls.

In your disclosure here and on page [XX], please tell us how you considered the disclosures required by Item 303(a)(3)(iii) of Regulation S-K. For example, in [Segment A] you only disclose that sales increased due to significant increases in . . . plant, . . . equipment and parts sales. . . . Further, where material, the effects of offsetting developments or events should be disclosed and, where changes are a result of several factors, you should disclose the relative extent of each material factor contributing to the increase or decrease. For example, in the second paragraph you disclose that international sales continue to be negatively impacted by the strengthening of the U.S. dollar compared to currencies in many of the countries in which you operate. In future filings, to the extent material, please quantify the impact of currency changes on your international sales and identify for investors the countries where your sales were most significantly affected by foreign currency fluctuations.
Accounting and Disclosure Considerations Related to Venezuela and Argentina Operations

The SEC staff continues to focus on accounting and disclosure considerations related to the foreign currency exchange environment in Venezuela. Business operations in Venezuela may give rise to accounting questions about (1) which exchange rate is appropriate for remeasurement and (2) whether such operations should be deconsolidated or considered impaired. For additional accounting and disclosure considerations related to the foreign currency exchange environment in Venezuela, see Appendix B.

- As indicated on page [XX], we note that during [XXXX] you changed the exchange rate used to remeasure your Venezuelan subsidiaries' non-U.S. Dollar denominated monetary assets and liabilities to the rate determined by an auction process conducted by Venezuela's Complementary System of Foreign Currency Administration (SICAD I), which was 10.0 to 1 compared to the historical indexed rate of 6.3 to 1. The devaluation resulted in a gain of $[XX] million for the six months ended June [XX, XXXX] due to your Venezuelan operations being in a net monetary liability position. Please provide disclosure regarding the fact that you made such a change and also disclose the facts and circumstances that led you to change this exchange rate.

Given the current economic situation in Argentina, the staff may begin to issue similar comments on operations in that country.

- We note your disclosure on page [XX] regarding the monetary and nonmonetary assets located in Argentina. Please expand your disclosure to clarify the nature of your operations in Argentina (e.g., manufacturing, importing, marketing, etc.) and the nature of the activities conducted between those operations and your non-Argentine operations. In addition, clarify how the economic situation in Argentina impacts your liquidity, including the extent of intercompany receivables due from your Argentine subsidiaries, to the extent material. Finally, quantify the amount of foreign currency translation losses attributed to your Argentine operations that are included in other comprehensive income as of the latest balance sheet date.

Translation Adjustments

Any adjustments that result from the translation of an entity's financial statements from its functional currency to the reporting currency should be recorded in other comprehensive income (i.e., such adjustments do not affect net income), and deferred taxes should be provided for the translation adjustments unless there is “sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation.” Further, entities must disclose an analysis of the changes in the CTA. This analysis can be presented in (1) a separate financial statement, (2) the notes to the financial statements, or (3) the statement of changes in equity. Regardless of the format in which the analysis is provided, it must contain the items listed in ASC 830-30-45-20. If an entity does not comply with this guidance, the SEC staff will most likely ask the registrant to revise its disclosures accordingly.

- We note your presentation of the change in the foreign currency translation adjustment includes the related tax benefit. Please describe for us the transactions and circumstances that resulted in recognizing a tax benefit related to the foreign currency translation adjustment. Refer to ASC 220-10-45-16 and ASC 830-30-40-1.

- Please revise your accounting policy disclosure to address how you account for the translation adjustments that result from the process of translating your financial statements from the functional currency of the [LC] to the reporting currency of the US dollar. Please refer to the
guidance in ASC 830-30-45. Also disclose the impact of translation adjustments and include an analysis of the changes in the accumulated amount of translation adjustments. Please refer to the guidance in paragraphs 830-30-45-12 and 830-30-50-1.

- Please expand your discussion and analysis of your consolidated financial results to include other comprehensive (loss) income as it relates to comprehensive income. For example, provide a discussion and analysis of the foreign currencies generating the foreign currency adjustments for the periods presented.

- Your consolidated statement of income and comprehensive income for the fiscal year ended June [XX, YYYY] and the disclosures in Note [X] indicate that foreign currency translation adjustments reduced your comprehensive income by $[XX] during this period. Given the significance of this amount to your total comprehensive income for the period, please tell us and revise the notes to your financial statements in future filings to disclose the changes in foreign currency exchange rates that resulted in this significant foreign currency translation adjustment for the period.

- Please expand your discussion and analysis of your consolidated results of operations to include other comprehensive (loss) income as it relates to comprehensive income. Specifically, we note that the components of other comprehensive loss resulted in the recognition of comprehensive income of $[XX] million as compared to consolidated net income of $[XX] million for fiscal year [YYYY] primarily due to currency translation and changes in the fair value of interest rate hedges accounted for as cash flow hedges. For currency translation adjustment, please provide a comprehensive discussion and analysis of the foreign currencies and transactions generating the foreign currency translation adjustments.

- We note that foreign currency translations adjustments materially impacted the change in comprehensive income from [XXXX] to [XXXX]. Please expand your discussion and analysis to provide a comprehensive discussion and analysis of the foreign currencies and transactions that led to the adjustments recognized.

- We note your presentation of the change in the foreign currency translation adjustment includes the related tax benefit. Please describe for us the transactions and circumstances that resulted in recognizing a tax benefit related to the foreign currency translation adjustment. Refer to ASC 220-10-45-16 and ASC 830-30-40-1.

- We note that other comprehensive loss resulted in a decrease to total comprehensive income of [XX]% for fiscal year [XXXX], which far exceeds the impact for the other periods presented. Please expand your disclosure to provide a comprehensive discussion and analysis of the foreign currencies and transactions generating the foreign currency adjustments that led to the adjustment recognized.

- We note that you recorded $[XX] billion in foreign currency translation losses which materially affected other comprehensive income for the year ended March [XX, YYYY]. Please expand your disclosure in future filings to discuss the nature and timing of the facts or circumstances that led to the significant translation loss. Please also discuss the changes in foreign currency rates and the related foreign operations which related to the translation loss. Please provide us with your proposed disclosures.
Appendix A — SEC Staff Review Process and Sample SEC Comments: Foreign Currency

Statement of Cash Flows — Foreign Currency
The SEC staff has also recently commented on the presentation of foreign currency effects within the statement of cash flows. These comments are particularly common when there seem to be inconsistencies within the financial statements as a whole. For example, the staff may raise a question when the effects of having international operations are presented or disclosed elsewhere (e.g., within the income statement, MD&A, or the notes to the financial statements) but the effects are not apparent in the statement of cash flows.

- We note you have international operations. Please tell us how you have complied with the guidance set forth in ASC 830-230-45-1 as it relates to your cash flow presentation.
- We note your Consolidated Statements of Cash Flows does not include a line item for the effect of exchange rate changes in cash. Please tell us if applicable to you and how you complied with the guidance set forth in ASC 830-230-45-1 as it relates to your cash flow presentation.
Appendix B — Economies Considered Highly Inflationary

Venezuelan Operations
The topic of highly inflationary economies has received particular attention in recent years given the economic environment in Venezuela, which has been considered highly inflationary since 2010 and which has had multiple exchange rates since this time.

Background on Exchange Rate Mechanisms
The Commission for the Administration of Foreign Exchange (CADIVI) until recently controlled the sale and purchase of foreign currency in Venezuela and set an official exchange rate of 6.3 BsF to 1 USD (the “official rate”). In 2013, the Venezuelan government authorized certain companies that operate in designated industry sectors to exchange a limited volume of BsFs for dollars at a bid rate established via weekly auctions under the Complementary System of Foreign Currency Acquirement (“SICAD 1”). These auctions became weekly starting in October 2013, and in late December 2013, the Venezuelan government authorized the Central Bank of Venezuela to begin publishing the average exchange rate resulting from the weekly SICAD 1 auction (the exchange rate determined at auctions during that time was approximately 11.3 BsF to 1 USD).

Effective January 24, 2014, additional changes to the country’s foreign exchange system were enacted by the Venezuelan government. The law (Convenio Cambiario 25) expanded the types of transactions that may be subject to the weekly SICAD 1 auction process while retaining the official rate of 6.3 BsF to 1 USD. In January 2014, the Venezuelan government also announced the replacement of CADIVI with a new foreign currency administration, the National Center for Foreign Commerce (CENCOEX).

In February 2014, the Venezuelan government announced plans for another currency exchange mechanism (“SICAD 2”), which:

- Was expected to provide a greater supply of USD from sources other than the Venezuelan government.
- Was expected to allow all sectors and companies to participate.
- Was regulated by the Venezuelan government.
- Permitted USD to be offered in cash or bonds.

The SICAD 2 rate was intended to more closely resemble a market-driven exchange rate than the rates provided by Venezuela’s other regulated exchange mechanisms (i.e., the official rate and the SICAD 1 rate). SICAD 2 became effective on March 24, 2014, and yielded an exchange rate significantly higher than the rates established through the other regulated exchange mechanisms (e.g., the SICAD 2 exchange rate closed at 50.86 BsF to 1 USD on March 31, 2014, compared with a closing rate of 10.70 BsF to 1 USD established at the last SICAD 1 auction in March 2014).
Appendix B — Economies Considered Highly Inflationary

Thus, as of March 31, 2014, an entity was able to convert BsF to USD at one of three legal exchange rates obtained via the following four exchange rate mechanisms:

- CENCOEX (official rate).
- CENCOEX (latest published SICAD 1 rate).
- SICAD 1 auction (SICAD 1 rate).
- SICAD 2 auction (SICAD 2 rate).

Almost one year later, the Marginal Currency System (Simadi) mechanism commenced operations on February 12, 2015, and was implemented as part of a law (Convenio No. 33), resulting in the elimination of the SICAD 2 rate. The Simadi rate was derived from daily private bidders and buyers exchanging offers through authorized agents and approved and published by the Venezuelan Central Bank. The Simadi exchange rate was quoted at 174 BsF to 1 USD on February 13, 2015; increased to approximately 188 BsF by mid-March; and closed at 193 BsF on March 31, 2015.

Finally, in February 2016, the Venezuelan government announced forthcoming changes to its foreign currency exchange mechanisms, including the devaluation of its official exchange rate. The changes became effective on March 10, 2016, with the enactment of Exchange Agreement No. 35, which:

- Replaced CENCOEX (Venezuela’s official exchange rate mechanism) with DIPRO, which is only available for purchases and sales of essential items. The official exchange rate was also devalued from 6.3 Venezuelan BsF to approximately 10 BsF to 1 USD.
- Eliminated the SICAD exchange rate mechanism, which last auctioned USD for approximately 13 BsF to 1 USD.
- Replaced the SIMADI exchange rate mechanism with DICOM, which is available for all transactions not subject to the DIPRO exchange rate and is intended to operate as a free-floating exchange rate mechanism. As of March 31, 2016, the DICOM exchange rate was approximately 272 BsF to 1 USD.

Accounting Considerations

Since 2010, Venezuela has been considered a highly inflationary economy; accordingly, an entity was required to remeasure the financial statements of its Venezuelan subsidiaries as if the subsidiaries’ functional currency were the entity’s reporting currency. As a result, as of January 1, 2010, each Venezuelan subsidiary of an entity that reports under U.S. GAAP began accounting for all BsF-denominated monetary transactions as foreign-currency-denominated transactions, which, under ASC 830, must be remeasured into the subsidiary’s functional currency (e.g., USD) in each reporting period, with changes in foreign currency rates related to BsF-denominated monetary balances recognized in earnings. ASC 830-20-30-3 indicates that to perform such remeasurement, entities should use the applicable rate(s) at which a transaction could be settled as of the transaction date to translate and record the transaction. Given the existence of multiple exchange rates, it has sometimes proved difficult for entities to make this determination in practice.
For the period ended December 31, 2013, entities reporting under U.S. GAAP generally used the official rate to remeasure BsF-denominated transactions in the financial statements of Venezuelan subsidiaries, since that rate was the only legal exchange rate available to most entities. Given recent developments, multiple exchange mechanisms and published exchange rates are now potentially available for remeasurement. Accordingly, entities will be required to reevaluate the exchange rate previously used for remeasurement. While the ultimate selection of an exchange rate (or multiple rates) should be based on an entity’s specific facts and circumstances, relevant factors for consideration include (but may not be limited to) the following:

- Whether the entity can legally use a specified rate (or multiple rates) to convert currency or settle transactions.
- Whether the exchange rates are published.
- The probability of accessing and obtaining USD by using a particular rate or exchange mechanism.
- The entity’s intent and ability to use a particular exchange mechanism.

Management will need to exercise significant judgment when considering the above factors. Accordingly, an entity should clearly document the facts and circumstances that it considered in its analysis of what exchange rate(s) to use for remeasurement. Because of the relatively frequent changes in exchange rate mechanisms, an entity may not have experience with settling transactions at certain exchange rates given the limited period in which these exchange rates have been available. Notwithstanding a lack of history at transacting at a particular exchange rate, an entity should be able to support (1) how the rate or rates used for remeasurement are most representative of the entity’s economic circumstances and (2) its intent to use the rate(s) or exchange mechanism(s) specified. An entity may also need to assess whether it should obtain a legal interpretation to sustain its assertion that it can access certain exchange rates and mechanisms.

**SEC Considerations**

In informal discussions, the SEC staff has observed that as a result of changes in the currency rate environment in Venezuela, an entity may, in certain circumstances, be able to support using a rate other than the official rate for remeasurement.

When determining the most appropriate exchange rate(s) for remeasurement of its Venezuelan operating subsidiary’s BsF-denominated monetary balances, an entity may find the following process helpful:

1. Identify transactions for which the Venezuelan government has granted approval to obtain USD at certain rates (including BsF-denominated monetary assets that will be required before approved USD-denominated liabilities can be settled) and remeasure by using the preapproved exchange rate(s).
2. For any remaining USD-denominated liabilities (i.e., those for which the Venezuelan government has not yet granted approval to settle by using USD obtained at certain rates), determine which mechanisms the entity can access to obtain USD, and remeasure the volume of BsF-denominated monetary assets needed to obtain those USD at the exchange rates that the entity expects to use when it settles the USD-denominated payables.
3. Remeasure any remaining net BsF-denominated monetary items by using the rates that are most representative of the entity’s economics and are most likely to be available to settle the transactions.
In response to the 2015 changes to exchange rates in Venezuela, the SEC staff reaffirmed factors that registrants should consider in selecting the exchange rate(s) to use for remeasurement or in assessing whether deconsolidation (see discussion below) of a Venezuelan subsidiary is warranted. The staff reiterated that:

- A registrant must exercise judgment when determining the exchange rate(s) that should be used to remeasure its BsF-denominated balances. That judgment should be based on the registrant's specific facts and circumstances.
- In U.S. GAAP, there is no support for use of a rebuttable presumption under which registrants should remeasure foreign currency monetary assets/liabilities by using the least favorable legal exchange rate when multiple legal exchange rates exist.
- A registrant that previously used the SICAD 2 rate to remeasure its BsF-denominated monetary assets/liabilities in prior periods should (1) consider all of the recent changes in the Venezuelan foreign exchange mechanisms and (2) consistently apply its rate selection approach (e.g., in the absence of any change in its specific facts or circumstances, if a registrant previously determined that it would be unable to use the official or SICAD 1 rates for remeasurement, it would generally be expected to reach the same conclusion in the new exchange environment, resulting in the use of the Simadi rate for remeasurement).
- Depending on facts and circumstances, it may be appropriate for a registrant to use multiple exchange rates for remeasurement.
- Registrants should continue to assess whether it is appropriate to continue consolidating their Venezuelan operations in accordance with ASC 810-10-15-10(a)(1)(iii) and ASC 830-20-30-2.
- Registrants with material Venezuelan operations should continue to provide transparent disclosures regarding the items described above.

Regardless of the rate selected, registrants should continue to maintain documentation of their rate selection analysis as well as the relevant facts and circumstances they considered in using their judgment to select an appropriate exchange rate or rates.

Entities with classified balance sheets should consider whether classifying certain BsF-denominated monetary assets as current is still appropriate in light of the present economic environment in Venezuela. For example, an entity's classification of assets as current may be inappropriate when such assets will be used to pay USD-denominated liabilities or dividends (rather than BsF-denominated liabilities) and the entity encounters difficulties in converting such assets into USD. Such a determination will depend on an entity's facts and circumstances and its ability to obtain necessary approvals to convert such balances at an appropriate exchange rate in the volume it needs to operate over the course of one year or its operating cycle, if longer.
Deconsolidation and Impairment Considerations

Volume restrictions on exchange activity in Venezuela (either explicit or in-substance), in conjunction with the uncertainties of obtaining approval for foreign exchange through the established exchange mechanisms, may cause an entity to question whether there is an other-than-temporary lack of exchangeability associated with its Venezuelan operations. Entities should consider the guidance in ASC 830-20-30-2, which states, in part:

If the 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 of the reporting entity shall be carefully considered.

Further, ASC 810-10-15-10 notes, in part:

A majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner — for instance, 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.

SEC Considerations

At the 2015 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed foreign subsidiaries of registrants operating in jurisdictions with foreign currency exchange or government restrictions, particularly when those restrictions are so severe that they cast doubt on registrants' ability to control the foreign subsidiaries. Specifically, the staff discussed the lack of currency exchangeability in, and other government restrictions related to, registrants' foreign operations in Venezuela.

In commenting on these situations, the staff noted that deconsolidation of a foreign subsidiary may be appropriate if the foreign exchange or government restrictions are so severe that the registrant lacks control of the subsidiary. The staff indicated, however, that if the equity investors have lost control of the subsidiary, registrants should carefully consider whether the foreign subsidiary is a VIE, emphasizing that in such circumstances, a registrant would need to consider ongoing disclosure of its variable interests, if any, in the foreign VIE in accordance with the disclosure requirements of ASC 810. In addition, the staff cautioned that a registrant would need to have internal controls to monitor changes in the facts and circumstances of the foreign exchange restrictions and government-imposed controls to determine whether the registrant has regained control and thus should reconsolidate the foreign subsidiary.

An entity's evaluation of whether deconsolidation of a foreign subsidiary is appropriate should be based on the entity's specific facts and circumstances. We believe that in making such a determination with respect to operations in Venezuela, an entity should consider factors that include, but may not be limited to, the following:

- Volume restrictions on currency exchange activity in Venezuela (either explicit or in-substance), in conjunction with the uncertainties about the entity's ability to obtain approval for foreign currency exchange through the established exchange mechanisms.
- The ability, currently and historically, to access available legal currency exchange mechanisms in volumes desired or needed by the entity.
- Recent developments in the downward trend of the price of oil and how that trend might affect expectations about the future direction of restrictions on currency exchange in Venezuela (i.e., the trend could adversely affect the Venezuelan government's supply of USD and thus further limit the amount of currency available through the established currency exchange mechanisms).
Appendix B — Economies Considered Highly Inflationary

• The extent and severity of restrictions imposed by the government on an entity’s Venezuelan operations and whether those restrictions demonstrate an entity's inability to control its Venezuelan operations. An entity will need to use considerable judgment in evaluating this factor, since many governments, including the U.S. federal government, require companies to make decisions within a framework of laws and regulations over operational matters such as those noted above.

The mere fact that currency exchangeability is lacking or that government controls exist may not in and of itself create a presumption that an entity should deconsolidate its Venezuelan operations, nor does the ability to exchange some volume of currency create a presumption that continued consolidation of Venezuelan operations is appropriate. However, the existence of the above factors represents negative evidence that an entity should consider in determining whether deconsolidation is appropriate on the basis of the entity's specific facts and circumstances.

If an entity ultimately concludes that deconsolidation is appropriate, the entity still must determine the appropriate date for deconsolidation, including the appropriate currency exchange rate to use for remeasuring its deconsolidated investment and any other outstanding monetary balances that are no longer eliminated in consolidation (provided that they are not considered fully impaired).

Regardless of whether consolidation is still considered appropriate, an entity should assess whether the severity of the foreign currency exchange controls represents a triggering event that would require it to assess its Venezuelan investments, long-lived assets, and any other outstanding balances of its Venezuelan operations for impairment.

SEC Considerations

The SEC staff has noted that to the extent applicable, registrants that provide disclosures about the financial statement impact of a deconsolidation event of a Venezuelan subsidiary should also disclose the amount of intercompany receivables that may no longer be eliminated in consolidation if such deconsolidation were to occur.

Similarly, entities that hold investments in Venezuelan operations accounted for under the equity and cost methods as well as available-for-sale Venezuelan debt or equity securities should assess whether an other-than-temporary impairment resulting from the operating and economic uncertainties in Venezuela may exist as of the balance sheet date.

SEC Considerations

During 2014, when many entities were performing this assessment as a result of the institution of multiple exchange rates in Venezuela, the SEC staff indicated that while a registrant is not required to seek a preclearance from the OCA for its conclusion to deconsolidate its Venezuelan operations, the staff would be willing to work with a registrant through a preclearance given the significant uncertainty regarding the foreign currency restrictions in Venezuela.

For example, through discussions with the SEC staff, we became aware that the staff did not object to a registrant’s conclusion to deconsolidate its Venezuelan operations as of December 2014. We understand that the two primary arguments cited by the registrant were (1) an other-than-temporary lack of currency exchangeability and (2) the existence of several government limitations on the registrant's ability to control its Venezuelan operations. Examples of government intervention might include restrictions on (1) labor force reductions, (2) decisions about product mix or pricing, and (3) sourcing of raw materials or other inputs into the production process.
For more information about deconsolidation accounting, see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.

**Need for Robust Disclosure**

In an environment with multiple legally accessible exchange rates, the basis for certain accounting decisions (e.g., the determination of the appropriate exchange rate(s) to use for remeasurement) may not be entirely clear. Accordingly, it is critical that entities provide robust disclosure in the notes to the financial statements as well as in the Description of Business, Risk Factors, and MD&A sections of their SEC filings. Entities should also clearly document their accounting conclusions and the underlying rationale as part of their internal control environment review and assessment process.

**SEC Considerations**

The SEC staff has indicated in informal discussions that a registrant should consider providing additional disclosures related to its Venezuelan operations if such disclosures are material. We believe that the following disclosures are consistent with those recommended by the SEC staff:

- The overall environment in Venezuela and its effect on the entity’s financial statements both historically and currently. This disclosure can include information about (1) price controls, inflation, and foreign currency exchange limitations or restrictions; (2) changes in the entity’s revenues and associated costs; and (3) any triggering events, impairment indicators, or impairments.

- The extent of the entity’s exposure to Venezuelan operations, including the nature of the entity’s activities in Venezuela (e.g., imports, manufacturing, and size of operations) and other meaningful financial information, such as disaggregated financial information about the Venezuelan operations (e.g., summarized balance sheets, income statements, and cash flow statements).

- A description of the possible effects of Venezuela’s currency exchange limitations or government restrictions on the entity’s operations, including how such limitations or restrictions may affect the entity’s liquidity, cash flows, or debt covenants. An entity should also describe how the existence of such limitations or restrictions affects the application of the entity’s accounting policies.

- The exchange rate(s) used for remeasurement and the basis for judgments made in determining the rate(s), including:
  - If multiple exchange rates are used, how each rate was determined, what transactions each rate applies to, and the relative significance of the various exchange rates.
  - Any volume restrictions or limitations on a particular exchange rate.
  - Any assumptions used in the determination of the appropriate exchange rate.
  - Any risks or uncertainties related to the entity’s ability to settle at the exchange rate selected.
  - A description of the use of any exchange rates that differ from those used in prior reporting periods.
In addition to the above, we believe that an entity should consider the following disclosures:

- The impact of remeasurement on the financial statements, including (1) the amount of any foreign exchange gain or loss that arises from using the various rates for remeasurement and (2) the financial statement line item in which the gain or loss is recorded.
- The amount of Venezuelan BsF that is awaiting government approval for settlement at the various rates and the time that has elapsed since such approval was requested.
- If applicable, ongoing disclosure of variable interests, if any, in foreign VIEs in accordance with the disclosure requirements of ASC 810.

**Connecting the Dots**

Because of the complexity of these accounting and disclosure issues, we encourage entities with Venezuelan operations to consult with their accounting advisers and legal counsel.

**Argentine Operations**

Venezuela is not the only country whose inflationary status is attracting attention. Argentina's inflation has also been scrutinized recently, highlighting the important role informed judgment can play in the determination of an economy's inflationary status.

**Argentina Inflationary Data Background**

Historically, the IMF has had concerns about the reliability of the inflation data produced by the government of Argentina. For example, the IMF provides the following background in its November 9, 2016, press release on its decision to lift its censure:

In July 2011, Argentina was found in breach of its obligations under [IMF] Article VIII, Section 5 due to its inaccurate provision of [consumer price index (CPI)] and [gross domestic product (GDP)] data. In light of Argentina's failure to remedy its inaccurate provision, the Executive Board subsequently issued a Statement of Concern and Declaration of Censure on September 17, 2012 and February 1, 2013, respectively, in accordance with the [IMFs] legal framework.

The IMF has continued to report the government-published Argentine CPI and GDP data every six months in its WEO report. In its April 2016 WEO report, the IMF issued the following warning:

The consumer price data for Argentina before December 2013 reflect the CPI for the Greater Buenos Aires Area (CPI-GBA), while from December 2013 to October 2015 the data reflect the national CPI (PCNPu). Given the differences in geographical coverage, weights, sampling, and methodology of the two series and the authorities' decision in December 2015 to discontinue the PCNPu, the average CPI inflation for 2014, 2015, and 2016 and end-period inflation for 2015 are not reported in the April 2016 World Economic Outlook. On February 1, 2013, the IMF issued a declaration of censure and in June 2015 called on Argentina to implement additional specified actions to address the quality of its official CPI data according to a specified timetable. The new government that took office in December 2015 has stated that it considers that the PCNPu is flawed and announced its determination to discontinue it and to improve the quality of CPI statistics. It has temporarily suspended the publication of CPI data to review sources and methodology. The Managing Director will report to the Executive Board on this issue again by July 15, 2016. At that time, the Executive Board will review the issue in line with IMF procedures.
In its October 2016 WEO report, the IMF indicated that Argentina's 2016 CPI inflation was projected to be 39 percent and its cumulative three-year inflation rate was projected to be 105 percent by the end of 2016. The report did not provide inflation data for 2015 for the same reasons the data was excluded from the April 2016 report (i.e., because of “the differences in geographical coverage, weights, sampling, and methodology”). However, it did include inflation data for earlier years, including the 2014 IPCNu rate of 24 percent and the 2013 and 2012 CPI-GBA rates of 11 percent and 11 percent, respectively. The report also noted that the “new government that took office in December 2015 discontinued the IPCNu, stating that it was flawed, and released a new CPI for the Greater Buenos Aires Area on June 15, 2016.” In addition, the report indicates that the Executive Board stated at its August 31, 2016, meeting that “important progress [had been] made in strengthening the accuracy of the CPI data.”

Accordingly, on November 9, 2016, the IMF decided to lift its censure on the reliability of data published by the new Argentine government. In the press release on the decision, IMF Managing Director Christine Lagarde stated the following:

> Today's IMF's Board decision to remove the Declaration of Censure is a testament to the extraordinary efforts made by the new Argentinean administration to strengthen the national statistics agency and produce reliable and trustworthy data. I would like to commend the authorities for their commitment to transparency and determination to improve the accuracy [of] official data in such a short period.

While the IMF's censure was removed, CPI inflation rates for November and December 2015 were not published, and no efforts were undertaken to determine whether the prior years' data should be adjusted. Therefore, as a result of the lack of publicly available information, the estimate of the cumulative inflation rate for three-year periods including 2015 had to be derived from a combination of any available national, regional, or local CPIs. For example, depending on the indexes used in the calculation, the three-year cumulative inflation in Argentina as of September 30, 2016, may or may not have exceeded 100 percent.

Because of the concerns raised by the IMF regarding the historical reliability of CPI inflation data, some stakeholders looked to qualitative factors to help them determine whether Argentina's economy was highly inflationary in late 2016. Others looked to the wholesale price index (WPI) produced by the Argentine government as a proxy for inflation data to be used in the three-year cumulative inflation calculation. The WPI consistently provided national coverage (unlike most of the published CPI data) and was viewed by some local practitioners as providing the most relevant and reliable inflation measures for the country as a whole, even though it is not a CPI. Further, information began to show that inflation had started to decelerate under the new government, and the expectation was that inflation could continue to decelerate given the new government’s anti-inflationary policies.

Accordingly, entities faced practical challenges and needed to use significant judgment in assessing whether Argentina's economy was considered highly inflationary in 2016.

**IPTF Highlights**

As discussed in Section 7.2.2, the International Practices Task Force (IPTF) is a committee of the Center for Audit Quality that meets periodically with the SEC staff to discuss issues related to international reporting and technical accounting.

The IPTF regularly monitors inflation information that may be relevant to an entity’s determination of whether a country may be considered highly inflationary.
Appendix B — Economies Considered Highly Inflationary

At its November 17, 2016, meeting with the SEC staff, as well as during a January 18, 2017, conference call, the IPTF discussed the three-year cumulative inflation rate for several countries, including Argentina. The published highlights of the November meeting contain the following summary of Argentina's three-year cumulative inflation rates:

<table>
<thead>
<tr>
<th>Indices Considered[*]</th>
<th>As of 9/30/16</th>
<th>As of 12/31/16</th>
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<tbody>
<tr>
<td>1 Various indices used — Greater Buenos Aires (CPI-GBA) to December 2013, IPCNu January 2014 to October 2015, City of Buenos Aires only index (IPC-GBA) November 2015 to April 2016, new CPI-GBA from May 2016 to relevant period-end</td>
<td>100.2%</td>
<td>104.2%</td>
</tr>
<tr>
<td>2 Same as #1 except that the San Luis province index (IPC-SL) was used instead of the IPC-BA for November 2015 to April 2016</td>
<td>98.3%</td>
<td>102.2%</td>
</tr>
<tr>
<td>3 National [WPI]</td>
<td>93.5%</td>
<td>90.9%**</td>
</tr>
</tbody>
</table>

[*] Other indices or combinations of indices are published in Argentina that registrants may also consider relevant in applying judgment to determining the best available rate that reflects the three-year cumulative inflation in Argentina.

[**] The decrease in the WPI rate from September 30, 2016, to December 31, 2016, is not the result of deflation in Argentina. Rather, it reflects the outcome of high inflation figures from 2013 that are no longer being incorporated into the cumulative-average rate as a result of the passage of time.

As the table illustrates, depending on the inflation data considered in the computation of the cumulative three-year inflation for the period ended December 31, 2016, the cumulative inflation rates may have been above or below 100 percent.

The meeting highlights also outline the IPTF’s discussion of how to consider the cumulative inflation data:

The Task Force is aware that in late December 2016, certain US accounting firms submitted a white paper to the SEC staff from the Office of the Chief Accountant that asserted that the firms would not require a registrant to consider Argentina's economy as highly inflationary under US GAAP for the reporting period from October 1, 2016 to December 31, 2016. The SEC staff from the Office of the Chief Accountant, after reviewing the white paper submitted by the firms, stated that the staff would not object to a calendar year-end registrant’s determination that Argentina’s economy would not be considered highly inflationary under US GAAP for the reporting period from October 1, 2016 to December 31, 2016.

The staff indicated that registrants with Argentine operations should continue to closely monitor the economic environment within the country and have appropriate processes in place to identify relevant inflation data in order to determine whether Argentina should be considered a highly inflationary economy on an ongoing basis.

The three-year cumulative inflation rates presented above as of December 31, 2016 reflect inflation data published by Argentina’s Bureau of Statistics in January with respect to December 2016. That data is relatively consistent with the data as of September 30, 2016 with WPI (the only consistently calculated national index) improving.

As a result, it does not appear that Argentina would be required to be considered highly inflationary under US GAAP for the reporting period from January 1, 2017 to March 31, 2017. However, the Task Force is not aware of any consultation with the staff regarding Argentina related to the January 1 to March 31, 2017 period.

Registrants should closely monitor all inflation data and conditions in Argentina throughout 2017 to determine whether there is a change that would result in Argentina being considered highly inflationary.
Monitoring and Disclosure Considerations

As the meeting highlights above note, the SEC staff specified that it would not object to a determination that, for the October 1, 2016, through December 31, 2016, reporting period, Argentina’s economy is not highly inflationary. In addition, the IPTF indicated that both the quantitative and qualitative considerations for the fourth calendar quarter of 2016 did not significantly change and that it therefore did not appear that Argentina must be considered highly inflationary for the period beginning on January 1, 2017. Nevertheless, registrants with material Argentine operations were encouraged to continue to closely monitor the economic environment within the country and to ensure that appropriate processes were in place for identifying relevant inflation data (i.e., inflation data published by Argentina’s Bureau of Statistics for periods after January 1, 2017) to determine whether highly inflationary treatment would be appropriate in a future period.

Further, given the continued scrutiny of Argentina’s inflationary status, entities with material operations in Argentina were encouraged to carefully consider the requirements in ASC 275 related to disclosing risks and uncertainties resulting from certain concentrations, including concentrations associated with foreign operations and therefore with exposure to foreign exchange risk.

In addition, SEC Regulation S-K, Item 303, requires registrants to disclose in their MD&A any known trends, events, or uncertainties that are reasonably likely to have a material effect on their liquidity, capital resources, or results of operations.

The SEC staff has also historically provided informal guidance for registrants with foreign operations that may be subject to material risks and uncertainties, such as political risks, currency risks, and business climate and taxation risks. The staff has reminded registrants that the effects on their consolidated operations of an adverse event related to these risks may be disproportionate to the size of their foreign operations. Therefore, the staff has historically encouraged registrants to discuss in their MD&A any trends, risks, and uncertainties related to their operations in individual countries or geographic areas and possibly to supplement such disclosures with disaggregated financial information about those operations.

In addition, SEC Regulation S-K, Items 503(c) and 305, require registrants to disclose risks, including risk factors and market risk. The SEC staff has emphasized that registrants should present tailored risk factors in their filings and avoid using boilerplate language. Therefore, registrants with operations in Argentina should consider whether to provide more specific discussion and enhanced explanations of how foreign currency risks could materially affect their business. This discussion may be supplemented with quantitative information that puts the risks in context.
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

The following are excerpts from Deloitte’s 2017 iGAAP Book, Chapter A19, The Effects of Changes in Foreign Exchange Rates, and Chapter A37, Financial Reporting in Hyperinflationary Economies. Requirements drawn from official IASB material are shown in unshaded text. Interpretative material supplementing the IASB guidance is highlighted by gray shading.

Chapter A19, The Effects of Changes in Foreign Exchange Rates

1 Introduction

1.1 Overview of IAS 21

IAS 21 The Effects of Changes in Foreign Exchange Rates outlines how to account for foreign currency transactions and operations in financial statements, and also how to translate financial statements into a presentation currency. An entity is required to determine a functional currency (for each of its operations, if necessary) based on the primary economic environment in which it operates and generally records foreign currency transactions using the spot conversion rate to that functional currency on the date of the transaction.

1.2 Amendments to IAS 21 since the last edition of this manual

IAS 21 was most recently amended in January 2016 by minor consequential amendments arising from IFRS 16 Leases (effective for annual periods beginning on or after 1 January 2019, with earlier application permitted). The amendments clarify items related to leases that should be classified as monetary and non-monetary (see 3.4.1).

2 Foreign currency transactions and scope of IAS 21

2.1 Foreign currency items within the scope of IAS 21

An entity may enter into foreign currency transactions in two principal ways:

- it may enter directly into transactions denominated in a foreign currency; and
- it may have foreign operations.

In addition, an entity may present its financial statements in a foreign currency.
IAS 21 prescribes how to account for transactions in a foreign currency and how to translate foreign operations for inclusion in the financial statements of an entity, whether by consolidation or the equity method. The Standard also addresses how to translate financial statements into a presentation currency. [IAS 21:3]

2.2 Foreign currency items excluded from the scope of IAS 21

IAS 21 excludes from its scope those foreign currency derivatives to which IFRS 9 Financial Instruments (or, for entities that have not yet adopted IFRS 9, IAS 39 Financial Instruments: Recognition and Measurement) applies (see chapters B4 and B5 or, for entities that have not yet adopted IFRS 9, chapters C4 and C5). Foreign currency derivatives that are not within the scope of IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39) (e.g. some foreign currency derivatives that are embedded in other contracts) are within the scope of IAS 21. In addition, IAS 21 applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency. [IAS 21:3 & 4]

Although IAS 21 defines a net investment in a foreign operation (see section 3), the accounting treatment for a hedge of a net investment of a foreign operation is dealt with in IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39). Similarly, IFRS 9 (IAS 39) applies to hedge accounting for a designated item hedged for foreign exchange risk. IAS 21 specifically excludes from its scope the measurement of foreign currency items that are subject to hedge accounting. [IAS 21:5] These items are discussed in chapter B9 (or, for entities that have not yet adopted IFRS 9, chapter C9) on hedge accounting.

Example 2.2
Hedging a net investment in a foreign operation

Company S, a Swedish entity with the Swedish krona as its functional currency, has a subsidiary with the US dollar as its functional currency. Company S has a third-party long-term debt agreement in the amount of US$4,000,000. Company S designates US$2,000,000 of the debt at the beginning of the year as a hedge of its net investment in the foreign subsidiary.

The part of the debt qualifying as a hedging instrument is outside the scope of IAS 21 and is instead accounted for under IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39). The portion of the debt instrument that is not designated in the hedging relationship is, however, still within the scope of IAS 21.

See chapter B9 (or, for entities that have not yet adopted IFRS 9, chapter C9) for guidance on hedges of net investments in a foreign operation and on hedge effectiveness.

IAS 21 does not address the presentation of cash flows arising from transactions in a foreign currency in a statement of cash flows, nor the translation of cash flows of a foreign operation; these issues are addressed in IAS 7 Statement of Cash Flows (see chapter A21). [IAS 21:7]

3 Reporting foreign currency transactions in the functional currency

3.1 Foreign currency transaction — definition

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency. [IAS 21:20] A foreign currency is a currency other than the functional currency of the entity. [IAS 21:8] For example, an entity may:

- buy or sell goods or services at a price denominated in a foreign currency;
- borrow or lend funds such that the amounts payable or receivable are denominated in a foreign currency; and/or
- acquire or dispose of assets, or incur or settle liabilities, denominated in a foreign currency.
When an entity directly enters into such transactions, it is exposed to the cash flow effects of changes in value of the foreign currency. An entity must convert foreign currency items into its functional currency in order to recognise those items in its accounting records. Once recognised, exchange differences will arise when changes in exchange rates affect the carrying amounts.

### 3.2 Functional currency

#### 3.2.1 Functional currency — general

The functional currency of an entity is the currency of the primary economic environment in which the entity operates. [IAS 21:8]

In preparing financial statements, each entity is required to determine its functional currency in accordance with IAS 21:9 to 14. This applies whether the entity is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch). There is no concept of a ‘group functional currency’ in IFRSs.

An entity’s functional currency is a matter of fact, not of choice. In practice, judgement is required in assessing which currency is the functional currency. Because this is a question of fact, an entity’s functional currency will change only if there is a change in the primary economic environment in which the entity operates (see 3.2.8.1).

#### 3.2.2 Primary indicators of a functional currency

IAS 21:9 explains that the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. When determining its functional currency, an entity considers:

[IAS 21:9]

(a) the currency that mainly influences sales prices for goods and services (which is often the currency in which those sales prices are denominated and settled) and the currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services; and

(b) the currency that mainly influences labour, material and other costs of providing goods or services (which will often be the currency in which such costs are denominated and settled).

It is widely accepted, for example, that prices for oil are determined in US dollars. Therefore, the sales prices of an entity whose primary activity is to sell oil are influenced by the US dollar. This is true regardless of the currency that appears on its sales invoices because, when that currency is a local currency, the local currency price will nevertheless have been determined by reference to the US dollar. As a consequence, such entities often have the US dollar as their functional currency, subject to the other primary indicators in IAS 21:9 (i.e. labour, material and other costs of providing the goods or services).
3.2.3 **Further indicators of a functional currency**

When determining its functional currency, an entity may also need to consider:

IAS 21:10

(a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and

(b) the currency in which receipts from operating activities are usually retained.

3.2.4 **Assessing whether the functional currency of a foreign operation is the same as that of a reporting entity to which it is related**

If an entity is a foreign operation, additional factors may also need to be considered in determining whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint arrangement:

IAS 21:11

(a) whether the activities of the foreign operation are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy. If the foreign operation only sells goods imported from that reporting entity and remits the proceeds to it, this will be an example of the former. An example of the latter is when the foreign operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency;

(b) whether transactions with that reporting entity are a high or a low proportion of the foreign operation’s activities;

(c) whether cash flows from the activities of the foreign operation directly affect the cash flows of that reporting entity and are readily available for remittance to it; and

(d) whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by that reporting entity.

If a foreign operation carries on business as if it were an extension of the reporting entity of which it is a subsidiary, branch, associate or joint arrangement, the functional currency of the foreign operation is the same as that of the reporting entity; it would be contradictory to assert that such a foreign operation (sometimes referred to as an ‘integral foreign operation’) operates in a primary economic environment different from the reporting entity of which it is a subsidiary, branch, associate or joint arrangement. [IAS 21:BC6]

3.2.5 **Identifying the functional currency when the indicators are mixed**

When indicators are mixed and the functional currency is not obvious, management should use judgement to determine the functional currency that most faithfully represents the economic effects of transactions, events and conditions. As part of this approach, management should give priority to the primary indicators in 3.2.2 before considering the indicators in 3.2.3 and 3.2.4. [IAS 21:12]
Consideration of the following additional factors, based on the nature of the foreign operation, may assist in the determination of functional currency.

- If an intermediate parent carries out duties related to the sub-group in which it holds investments (e.g. if the intermediate parent has different directors/employees from the ultimate parent entity, has its own reporting responsibilities, produces consolidated financial statements including the sub-group, actively manages a series of operations in a geographical area and, therefore, incurs costs in a local currency), this would indicate that the functional currency of the entity is not necessarily the same as that of its parent entity. If the intermediate parent exists solely in order for the ultimate parent to obtain a tax, regulatory, jurisdictional or legal type of benefit it would not otherwise receive, this indicates that it is an extension of its parent entity.

- If the foreign operation is clearly set up as a structured or special purpose entity, its activities are being conducted on behalf of the parent entity (e.g. employee benefit trusts, leasing vehicles etc.) and the structured or special purpose entity is an extension of the parent entity, this indicates that it should have the same functional currency as that of the parent entity.

- For a treasury entity, it is necessary to assess whether it exists (1) to serve the funding and cash management needs of the group as a whole (i.e. it constitutes an extension of the parent entity), or (2) solely to service a specific sub-group. In the latter case, the functional currency of the treasury entity may be different from that of the parent entity.

- A ‘money-box’ entity is an entity that holds cash only. In accordance with the factors in IAS 21:9 to 12, it is not the currency of the cash that the entity holds that is the deciding factor in determining functional currency. Consistent with the bullet points above, it is necessary to consider for whose benefit the money-box entity exists, which will determine its functional currency.

**Example 3.2.5**

**Identifying the functional currency**

Company M has identified the Euro as its functional currency. Company M establishes two entities, Company P and Company Q. Company P is incorporated in the US and Company Q is incorporated in the UK. The following transactions occurred:

- Company M loaned £2 million each to Company P and Company Q, and both recognised the advance as an intragroup payable;
- Company Q borrowed an additional £3 million from an unrelated third party. Company P guaranteed this third party loan;
- Company Q invested its entire £5 million in building a manufacturing facility to serve the domestic UK market. Company Q intends to repay the loan to the third party from the profit generated through its manufacturing operations (which generate cash flows in Sterling); and
- Company P used its £2 million loan from Company M to invest in marketable securities in international markets. Its investing strategies are determined by Company M. Company P does not have any other activities or purposes.
Example 3.2.5
Identifying the functional currency (continued)

What are the functional currencies of Company P and Company Q?

In general, the functional currency identified for an entity should provide information about the entity that is useful and reflects the economic substance of the underlying events and circumstances relevant to that entity. If a particular currency is used to a significant extent in, or has a significant impact on, the entity, that currency may be an appropriate currency to be used as the functional currency.

In the circumstances described, it is likely that Sterling would be identified as Company Q's functional currency because that is the currency of the country that influences the sale prices and costs of its goods, as well as the regulations and competitive forces under which it operates.

On the other hand, even though Company P is domiciled in the US, it does not appear to have a significant degree of autonomy and its activities (investing in marketable securities) appear to be carried out as an extension of Company M. Consequently, in accordance with IAS 21:11(a), it is likely that the Euro would be identified as Company P's functional currency.

3.2.6 Identifying the functional currency of an investment fund

Some features common to investment funds include the following (the list is not exhaustive).

- Investors in the fund subscribe and redeem their investments in a specific currency. It may not be permitted, depending on the fund's policies or regulatory requirements, to subscribe or redeem such investments in any other currency.

- The fund may conduct its investment activities through subsidiaries set up in various jurisdictions to take advantage of tax treaties, double taxation agreements and concessions.

- The investment fund's policies may allow it to invest in various securities regardless of jurisdiction, industry or currency. Consequently, investment transactions and the related income and expenses may be denominated in several currencies.

- Investment management fees may be invoiced and received in a specific currency.

- Other costs of operating the fund may be denominated in the local currency of the jurisdiction in which the fund physically operates.

Given these complexities, how should the functional currency of an investment fund be identified?

IAS 21:12 clarifies that, in determining the functional currency of an entity, management should consider the guidance in IAS 21:9 to 11 (see 3.2.2 to 3.2.4) – giving IAS 21:9 priority before considering IAS 21:10 and 11.

IAS 21:12 also states that, when the indicators in IAS 21:9 to 11 are mixed and the functional currency is not obvious “management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions”.

In the context of an investment fund, IAS 21:9 does not seem immediately relevant and is difficult to apply because its factors are directed towards entities that provide goods and services. However, the same underlying principle can be applied to a fund with a mandate to buy and sell securities to generate a return for investors. Hence, the currency of the country whose competitive forces and regulations mainly determine the fund's revenue should be considered when determining the functional currency. In addition, the currencies in which the fund's labour costs and operating expenses are sourced and incurred should also be considered.
However, when a fund's functional currency is not obvious from the analysis above, consideration of the secondary indicators in IAS 21:10 (see 3.2.3) may provide additional evidence. The currency in which the fund raises finance from investors (i.e. the investor's participation in a fund) and makes distributions to investors (e.g. on redemption) should be considered. The currency in which dividends on investments or interest inflows are received and retained will provide additional evidence of the functional currency.

The indicators in IAS 21:11 (see 3.2.4) should also be considered if they are relevant to an investment fund (in a foreign operation).

### 3.2.7 Functional currency is the currency of a hyperinflationary economy

When the functional currency is the currency of a hyperinflationary economy, the entity's financial statements are restated in accordance with IAS 29 *Financial Reporting in Hyperinflationary Economies* (see chapter A37). An entity cannot avoid restatement in accordance with IAS 29 by, for example, adopting as its functional currency a currency other than the functional currency determined in accordance with IAS 21 (such as the functional currency of its parent). [IAS 21:14]

### 3.2.8 Change in functional currency

#### 3.2.8.1 Circumstances in which an entity's functional currency can be changed

As noted at 3.2.1, the functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once determined, the functional currency can be changed only if there is a change to those underlying transactions, events and conditions. [IAS 21:13]

For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency. [IAS 21:36]

**Example 3.2.8.1A**

**Impact of foreign currency borrowings on functional currency**

Company K's functional currency is the Euro. Company K accounts for its 43 per cent investment in Company M, a Mexican entity, using the equity method of accounting. Company M's functional currency is the Mexican peso. During the current year, Company M entered into a 200 million Euro third-party borrowing denominated in Euro. Most of Company M's operations, labour costs and purchases are denominated in the peso and incurred in the domestic market.

Is it appropriate for Company M to change its functional currency from the peso to the Euro?

Because the majority of Company M's operations, sales, purchases, labour costs etc. are denominated in the Mexican peso, and Mexico is the country that drives the competitive forces and regulations of that entity, Company M should continue using the Mexican peso as its functional currency. Although, in accordance with IAS 21:10, a large third-party financing in a different currency may in some circumstances provide evidence to support a change in functional currency, greater weight must be given to the factors discussed in IAS 21:9 (sales, purchases, labour costs etc.). Accordingly, in the circumstances described, the new financing is not sufficient, in and of itself, to justify a change in the functional currency from the peso to the Euro.
Example 3.2.8.1B
Change in functional currency

KI, located in Ireland, is a wholly-owned subsidiary of Company K. The US dollar is Company K's functional currency and KI has previously identified the Euro as its functional currency. The functional currency was identified because KI's sales and purchases were denominated primarily in Euro, as were all of KI's labour costs.

During the fourth quarter, KI's operations began to change. KI's sales decreased due to a loss of some sizable contracts while Company K's sales increased due to new significant contracts. Company K began using KI's manufacturing facilities in order to meet its sales orders. KI closed down its sales department because KI will no longer need to generate its own sales as more than 80 per cent will originate from Company K's operations. In addition, Company K has built a new facility to produce the materials needed in KI's manufacturing processes. As at the end of the reporting period, KI began receiving all materials from Company K instead of from outside suppliers.

Based on the changes in KI's business, KI expects cash inflows and outflows, except for wages, primarily to be denominated in US dollars.

IAS 21:36 states that a change in the currency that influences mainly the sales prices of goods and services may lead to a change in functional currency. In addition, the changes in KI's activities may be such that they are now primarily an extension of the reporting entity, Company K, as discussed in IAS 21:11(a).

There is evidence to suggest that KI's functional currency may have changed. Firstly, the currency of revenues has changed from the Euro to primarily the US dollar. This change does not appear to be temporary because the sales department has been closed down. Secondly, the currency of cash outflows for materials has also changed to the US dollar. Company K has built a new facility that will make these materials, so this change does not appear to be temporary either. Lastly, the position of KI's operations within Company K's overall operating strategy has changed, from a self-supporting, stand-alone operating entity to what is primarily a manufacturing facility of Company K.

3.2.8.2 Date at which change in functional currency is recognised

A change in functional currency should be reported as of the date it is determined that there has been a change in the underlying events and circumstances relevant to the reporting entity that justifies a change in the functional currency. This could occur on any date during the year. For convenience, and as a practical matter, there is a practice of using a date at the beginning of the most recent period (annual or interim, as the case might be).

In accordance with IAS 21:35, when there is a change in an entity's functional currency, the entity applies the translation procedures applicable to the new functional currency prospectively from the date of the change.

In other words, all items are translated into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation (see section 6). [IAS 21:37]

See 5.8 for an example of a change in both the functional and the presentation currencies.

An entity should disclose when there has been a change in functional currency, and the reasons for the change (see 9.2).
3.2.8.3 Change in functional currency – reassessment of liability/equity classification

A change in functional currency may lead to a reassessment of the liability/equity classification of a financial instrument (see section 8 of chapter B3 or, for entities that have not yet adopted IFRS 9, section 8 of chapter C3 for further discussion).

3.3 Initial recognition of foreign currency transactions

3.3.1 Transactions to be recognised at spot rate at the date of the transaction

The functional currency amount at which transactions denominated in foreign currencies should initially be recognised will be determined by using the exchange rate appropriate to the transaction. This is the spot rate between the functional currency and the foreign currency at the date of the transaction. [IAS 21:21] The date of the transaction is the date on which the transaction first qualifies for recognition in accordance with IFRSs. [IAS 21:22]

Example 3.3.1 Initial recognition of purchase of inventories

An entity with a functional currency of Sterling buys inventories for US$15,000. The spot rate is £1 = US$1.50. The inventories are measured at initial recognition at £10,000 (US$15,000/1.50).

3.3.2 Use of average rate that approximates the actual rate

For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used. For example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. If exchange rates fluctuate significantly, however, the use of the average rate for a period is inappropriate. [IAS 21:22]

It is common practice for entities that engage in a large number of foreign currency transactions to fix, for a period, the rate of exchange used to measure those transactions in their accounting records and to disregard day-to-day fluctuations in exchange rates. When this approach is used, care must be taken to ensure that the carrying amount of non-monetary assets (e.g. inventories or property, plant and equipment) is not materially different from what it would have been if actual rates had been used for translation. The actual rates should be used if a material difference would arise compared to average rates (e.g. to measure large one-off transactions such as the acquisition of property, plant and equipment or if there is a significant and unexpected movement in exchange rates).

IAS 21 clearly acknowledges that some degree of approximation is acceptable. It will be a matter of judgement, on the basis of an entity’s specific facts and circumstances, whether it is appropriate to derive an average rate for the entire year or whether the year should be analysed into shorter periods (e.g. quarterly periods, months or weeks) with an average rate determined for each.

3.4 Reporting foreign currency items at the end of subsequent reporting periods — monetary items

3.4.1 Monetary items — definition

Monetary items are defined as units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. [IAS 21:8]
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

Under IAS 21, foreign currency monetary items are treated differently from foreign currency non-monetary items. The essential feature of a monetary item is the right to receive (or the obligation to deliver) a fixed or determinable number of units of currency. [IAS 21:16] Conversely, a non-monetary item does not carry this right or obligation.

The following table lists a number of the most common monetary and non-monetary items.

<table>
<thead>
<tr>
<th>Monetary items</th>
<th>Non-monetary items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>Bank balances and loans</td>
<td>Intangible assets</td>
</tr>
<tr>
<td>Deposits*</td>
<td>For entities that have adopted IFRS 16, right-of-use assets</td>
</tr>
<tr>
<td>Employee benefit liability**</td>
<td>Goodwill</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>Shareholders' equity</td>
</tr>
<tr>
<td>Trade payables</td>
<td>For entities that have not yet adopted IFRS 16, prepaid rent</td>
</tr>
<tr>
<td>Taxation payable / refundable</td>
<td>Investments in associates</td>
</tr>
<tr>
<td>Debt securities</td>
<td>Advances received on sales or paid on purchases provided that they are linked to specific sales or purchases</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>Inventories</td>
</tr>
<tr>
<td>Allowance for doubtful debts (because trade receivables are monetary)</td>
<td>Allowance for inventory obsolescence (because inventories are non-monetary)</td>
</tr>
<tr>
<td>Notes and other receivables</td>
<td>Deferred income</td>
</tr>
<tr>
<td>Notes and other payables</td>
<td>Equity securities</td>
</tr>
<tr>
<td>Accrued income</td>
<td>Provisions to be settled by the delivery of a non-monetary asset</td>
</tr>
<tr>
<td>Holiday pay provision</td>
<td></td>
</tr>
<tr>
<td>Deferred tax assets/liabilities</td>
<td></td>
</tr>
<tr>
<td>Lease liabilities (or, for entities that have not yet adopted IFRS 16, payables under finance leases)</td>
<td></td>
</tr>
</tbody>
</table>

* When an entity has made a prepayment it is necessary to consider whether it is refundable. When it is refundable, it is similar in nature to a deposit and, therefore, is a monetary item (i.e. it is a right to receive a fixed or determinable number of units of currency). Conversely, when it is not refundable, it is non-monetary (see IAS 21:16).

** In practice, it is usually appropriate to regard a defined benefit asset or obligation as a monetary item. But it is possible to argue that some components, particularly relating to equity securities, should be regarded as non-monetary. However, for most entities, this would lead to a level of complexity that is unwarranted. It is relatively uncommon for a defined benefit arrangement to be denominated in a currency other than the functional currency of the entity.
A contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of currency units is also a monetary item. [IAS 21:16]

For example, an issued US$100,000 loan note repayable in ordinary shares to the value of US$100,000 meets the definition of a monetary item.

When preference shares are classified as debt by the issuer, they are typically a monetary liability for the issuer and a monetary asset for the holder. When preference shares are classified as equity by the issuer, they are recognised in equity by the issuer, typically using the rate on the date that they were issued. They are a non-monetary asset for the holder and, on initial recognition, are typically recognised using the rate on the date that they were acquired. Such assets may often subsequently be measured at fair value and the fair value should reflect the rate at the date of the valuation.

**3.4.2 Reporting monetary items at the end of subsequent reporting periods**

At the end of each reporting period, foreign currency monetary items are translated using the closing rate, i.e. the spot exchange rate at the end of the reporting period. [IAS 21:23(a)]

**Example 3.4.2**

*Translation of foreign-currency denominated revenue with refundable cash-advance receipt*

Entity A, whose functional currency is Japanese yen (JPY), is a 31 December year-end entity.

On 31 August 20X1, Entity A enters into an agreement to sell goods to a third-party customer in the United States for US$1,000. On 30 September 20X1, Entity A receives a cash advance of US$100 from the US customer. The customer has the right to demand repayment of the advance at any time up to delivery of the goods on 28 February 20X2.

Key events and foreign exchange rates prevailing on each date are summarised below. Note that, for simplicity, the effect of the time value of money is ignored.

<table>
<thead>
<tr>
<th>Dates</th>
<th>Events</th>
<th>FX Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 August 20X1</td>
<td>Agreement</td>
<td>US$1 = JPY70</td>
</tr>
<tr>
<td>30 September 20X1</td>
<td>Receipt of cash advance</td>
<td>US$1 = JPY80</td>
</tr>
<tr>
<td>31 December 20X1</td>
<td>Reporting year end</td>
<td>US$1 = JPY90</td>
</tr>
<tr>
<td>28 February 20X2</td>
<td>Revenue recognition</td>
<td>US$1 = JPY100</td>
</tr>
<tr>
<td>31 March 20X2</td>
<td>Receipt of final payment</td>
<td>US$1 = JPY105</td>
</tr>
</tbody>
</table>

In these circumstances, the advance received represents a continuing exposure to exchange rate fluctuations for Entity A, and it meets the definition of a monetary item under IAS 21:8 (see 3.4.1). Consequently, the advance received should be retranslated at the end of Entity A’s reporting period and until it becomes non-refundable (in this example, 28 February 20X2). The following entries are recorded.
Example 3.4.2
Translation of foreign-currency denominated revenue with refundable cash-advance receipt (continued)

On 30 September 20X1, the receipt of the cash advance is recorded as follows.

<table>
<thead>
<tr>
<th>JPY</th>
<th>JPY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cash (US$100 × 80)</td>
<td>8,000</td>
</tr>
<tr>
<td>Cr Advance received (deferred revenue)</td>
<td>8,000</td>
</tr>
</tbody>
</table>

Retranslation of the refundable cash advance at 31 December 20X1 is recorded as follows.

<table>
<thead>
<tr>
<th>JPY</th>
<th>JPY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Foreign exchange loss (profit or loss)</td>
<td>1,000</td>
</tr>
<tr>
<td>Cr Advance received (US$100 × (90-80))</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Retranslation of the refundable advance and revenue recognition on 28 February 20X2 are recorded in the following entries.

<table>
<thead>
<tr>
<th>JPY</th>
<th>JPY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Foreign exchange loss (profit or loss)</td>
<td>1,000</td>
</tr>
<tr>
<td>Cr Advance received (US$100 × (100-90))</td>
<td>1,000</td>
</tr>
<tr>
<td>Dr Advance received</td>
<td>10,000</td>
</tr>
<tr>
<td>Dr Trade receivables (US$900 × 100)</td>
<td>90,000</td>
</tr>
<tr>
<td>Cr Revenue (US$1,000 × 100)</td>
<td>100,000</td>
</tr>
</tbody>
</table>

When the final settlement is received on 31 March 20X2, the following entry is recorded.

<table>
<thead>
<tr>
<th>JPY</th>
<th>JPY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cash (US$900 × 105)</td>
<td>94,500</td>
</tr>
<tr>
<td>Cr Trade receivables</td>
<td>90,000</td>
</tr>
<tr>
<td>Cr Foreign exchange gain (profit or loss)</td>
<td>4,500</td>
</tr>
</tbody>
</table>

3.4.3 Recognition of exchange differences arising on monetary items — general

Exchange differences arise on:

- settlement of monetary items at a date subsequent to initial recognition; and
- remeasurement of an entity's monetary items at rates different from those at which they were either initially recognised (if in the period) or previously measured (at the end of the previous reporting period).

Such exchange differences must be recognised in profit or loss in the period in which they arise, except as described in 3.4.4. [IAS 21:28]
As noted in 2.2, however, if an item is within the scope of IFRS 9 Financial Instruments (or, for entities that have not yet adopted IFRS 9, IAS 39 Financial Instruments: Recognition and Measurement) (e.g. it is a foreign currency derivative within the scope of IFRS 9 or IAS 39 or a debt instrument that qualifies as a hedging instrument), IAS 21 does not apply and IFRS 9 (or IAS 39) should be applied instead.

An exchange difference on a foreign currency monetary item occurs when there is a change in the exchange rate between the transaction date and the date of settlement. When the transaction is settled within the same accounting period as that in which it occurred, the entire exchange difference is recognised in that period. When the transaction is settled in a different accounting period to that in which it occurred, the exchange difference to be recognised in each period is determined by the change in exchange rates during that period. [IAS 21:29]

**Example 3.4.3A**

**Exchange differences arising on borrowings denominated in a foreign currency**

Exchange gains or losses are the result of movements in the exchange rate between the functional currency of an entity and the foreign currency in which receivables or payables are denominated. For example, an entity has the US dollar as its functional currency and it has borrowed Japanese yen resulting in a yen-denominated payable. Exchange gains or losses should be recognised in profit or loss on the outstanding yen-denominated debt for changes in the spot rate of exchange between the Japanese yen and the US dollar at the end of the reporting period.

**Example 3.4.3B**

**Foreign currency defined benefit post-employment benefit plan**

Entity A has a defined benefit post-employment benefit plan that invests in UK securities under which the benefits to employees are denominated in Sterling. The functional currency of Entity A, determined in accordance with IAS 21, is the US dollar.

Entity A classifies pensions and other employee benefits to be paid in cash as monetary items in accordance with IAS 21:16 (see 3.4.1). Therefore, at the end of each reporting period, the post-employment benefit asset or liability should be translated using the closing rate. The foreign exchange exposure arises as a result of the functional currency of Entity A (i.e. the post-employment benefit plan itself is not affected by the US dollar). Consequently, any exchange difference arising from the translation of the post-employment benefit asset or liability at the end of the reporting period represents a foreign currency exposure for Entity A, and should be recognised in profit or loss in accordance with IAS 21:28. Amounts recognised in profit or loss in accordance with paragraph 120 of IAS 19 Employee Benefits (see 7.5.1 in chapter A15) are generally translated using the average rate as an approximation of the exchange rates at the dates of the transactions.

**Example 3.4.3C**

**Remeasurement of a decommissioning obligation expected to be paid in a foreign currency**

The appropriate treatment for the remeasurement of a decommissioning obligation expected to be paid in a foreign currency depends on whether the decommissioning obligation is a financial liability in the scope of IAS 32 Financial Instruments: Presentation, or a provision in the scope of IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

A decommissioning obligation qualifies as a financial liability under IAS 32:11 only if there is a contractual obligation to deliver cash or another financial asset to settle the obligation. Financial liabilities are monetary items for the purposes of IAS 21:23(a) (see 3.4.1) and 28 and, therefore, a foreign currency denominated decommissioning obligation that meets the definition of a financial liability is translated at the closing rate at the end of each reporting period and any exchange differences arising are recognised in profit or loss in the period in which they arise.
Example 3.4.3C
Remeasurement of a decommissioning obligation expected to be paid in a foreign currency (continued)

A decommissioning obligation that does not meet the definition of a financial liability is accounted for as a provision within the scope of IAS 37 (see chapter A12). IAS 37:14 requires that a provision be recognised when (1) the entity has a present obligation (legal or constructive) as a result of a past event, (2) it is probable that an outflow of resources will be required to settle the obligation, and (3) a reliable estimate can be made of the amount of the obligation. A provision is subject to subsequent adjustments reflecting revisions to the original estimate or timing of undiscounted cash flows to settle the obligation.

A provision, therefore, is not a contractual obligation to deliver a fixed or determinable foreign currency denominated amount. An entity may estimate the expected outflow in a foreign currency (discounting these cash flows with the appropriate interest rate relevant to the foreign currency) and then convert the provision into functional currency using the spot rate at the date the provision is recognised. This is all part of the estimation process which should be accounted for in accordance with IFRIC Interpretation 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities. The required accounting treatment for changes in the estimated outflow of resources required to settle the obligation (including any exchange differences) depends on whether the related asset is measured using the cost model or using the revaluation model, and is outlined in IFRIC 1:5 to 7 (see 4.4 in chapter A7).

3.4.4 Recognition of exchange differences arising on monetary items that form part of the net investment in a foreign operation

3.4.4.1 Monetary items that form part of the net investment in a foreign operation

The net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation. [IAS 21:8]

An entity may have a monetary item that is receivable from, or payable to, a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, part of the entity's net investment in that foreign operation. An example is a long-term financing loan to the foreign operation with no fixed repayment terms, for which management confirms that repayment is neither planned nor likely to occur in the future. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables. [IAS 21:15]

Exchange gains or losses on monetary items that form part of the net investment in a foreign operation are recognised in accordance with IAS 21:32 and 33 (see 3.4.4.2).

IAS 21 does not specify a time period that might qualify as the 'foreseeable future'. Therefore, the term 'foreseeable future' does not imply a specific time period, but is an intent-based indicator, i.e. an intragroup receivable or payable may qualify as part of the net investment in the foreign operation when:

- the parent does not intend to require repayment of the intragroup account (which cannot be represented if the debt has a maturity date that is not waived); and
- the parent's management views the intragroup account as part of its investment in the foreign operation.

A history of repayments is likely to be indicative that an advance or loan does not form part of the investment in a foreign operation.
Example 3.4.4.1A  
Rolling or minimum intragroup balances viewed as long-term investments

Company A, with the Singapore dollar as its functional currency, advances Euro to its foreign subsidiary, Company B. Company B has identified the Euro as its functional currency. Company B may repay some of the advances but, generally, they are replaced with new advances within a very short time frame (e.g. three to five days). In total, Company B generally has 50 million Euro advances outstanding at all times.

It is not appropriate for Company A to treat the Euro advances as part of its net investment in Company B because rolling balance and minimum balance intragroup accounts generally do not form part of the net investment in a foreign operation under IAS 21. IAS 21:15 specifically excludes trade receivables and trade payables as qualifying assets and liabilities. Intragroup transactions must be evaluated on an individual basis, not on an aggregate or net basis.

Example 3.4.4.1B  
Parent guarantee of foreign subsidiary's debt

A Swiss entity, Company R, has a Mexican subsidiary, Company S, with the Mexican peso as its functional currency. Company S borrows Swiss francs from a Swiss bank and Company R guarantees repayment of the loan. Company R has the ability to provide an intragroup loan to Company S, but decided not to do so for tax reasons. Interest payments are made by Company S, and not Company R. It is not anticipated that the subsidiary itself will repay the loan in the foreseeable future.

Although Company R has guaranteed its subsidiary's foreign-currency denominated debt to a third party, that guarantee will not bring the third-party loan within the scope of its net investment in the subsidiary as set out in IAS 21:15. Consequently, the translation gains or losses on the Swiss franc-denominated bank debt are recognised in profit or loss, both in Company S's financial statements and in Company R's consolidated financial statements.

Example 3.4.4.1C  
Foreign-currency denominated intragroup payables arising in the normal course of business

Company J, a Japanese parent, has a wholly-owned Mexican subsidiary, Company M. Company M's sales to third parties are denominated in Mexican pesos, as are its labour costs. Raw material purchases from Company J are denominated in Japanese yen and have resulted in intragroup payables to Company J that are also denominated in Japanese yen. In previous reporting periods, Company M has made cash repayments to Company J relating to these payables. However, no fixed repayment terms have been agreed for the intragroup payables. Although no specific amount has been formally designated as such, the management of Company M believes that a portion of the amounts due to Company J are of a long-term nature.

It is not appropriate for the portion of the amounts due that are of a long-term nature to be considered part of Company J's net investment in Company M because IAS 21:15 specifically excludes trade receivables and payables from forming part of an entity's net investment in a foreign operation. Therefore, such balances do not qualify for the exception in IAS 21:15. Moreover, the fact that Company M has made previous cash repayments to Company J leads to a presumption that Company M has the intent to repay the intragroup payables.

However, if Company M negotiates a separate financing long-term advance with its parent, Company J, such that repayment of the advance is not planned or anticipated in the foreseeable future, gains or losses resulting from future foreign currency fluctuations may be accounted for as part of Company J's net investment prospectively from the date of the advance or note payable.
Example 3.4.4.1D
Short-term intragroup debt

Company C is a wholly-owned US subsidiary of Company D, a Dutch-based parent. Company C has notes due to Company D that are denominated in Euro. The notes have stated maturities ranging from six months to one year. Although the notes are short-term by contract, the parent provides a representation each year that it will not demand repayment in that year. Historically, the notes have been renewed each year.

The short-term notes do not qualify for the exception in IAS 21:15.

In order to qualify as long-term investment, settlement must neither be planned nor likely to occur in the foreseeable future. Rolling intragroup balances generally do not form part of the net investment in a foreign operation under IAS 21:15. In the circumstances described, the parent has only represented that it will not require repayment in that year on the rolled-over short-term notes. It has not represented that it will not demand repayment of the notes in the foreseeable future.

Example 3.4.4.1E
Replacement of foreign-currency denominated debt with a long-term advance

Company L is a Lesotho subsidiary of Company S, a South African parent. Company L has the loti as its functional currency and Company S has the South African rand as its functional currency. Company L has taken out third-party rand-denominated debt which gives rise to exchange losses. In a restructuring of finances, Company S will repay Company L’s foreign currency (rand) denominated debt and Company S will advance replacement funds to Company L denominated in the loti.

It would not be appropriate in this transaction for Company S to consider the exchange differences arising on settlement of the third-party rand-denominated debt as relating to its net investment in Company L. The intragroup borrowing and settlement of third-party debt should be accounted for separately.

Although IAS 21:15 discusses the accounting for an intragroup foreign currency advance that is of a long-term nature, the transactions should be accounted for as they occur. Therefore, any foreign currency adjustments related to settlement of the third-party debt should be recognised in profit or loss in the period in which the exchange rate changes. However, if the advance from Company S to Company L is of a long-term nature for which settlement is not planned or anticipated in the foreseeable future, it may be treated as part of Company S’s net investment in Company L pursuant to IAS 21:15.

Example 3.4.4.1F
Foreign currency perpetual loan

Entity A, whose functional currency is Sterling, has a foreign operation in the form of a wholly-owned subsidiary, Entity B, with a Euro functional currency. Entity B issues to Entity A perpetual debt (i.e. the debt has no maturity) denominated in Euro with an annual interest rate of 6 per cent. The perpetual debt has no issuer call option or holder put option. Thus, contractually, it is just an infinite stream of interest payments in Euro.

In Entity A’s consolidated financial statements, the perpetual debt is appropriately considered a monetary item “for which settlement is neither planned nor likely to occur in the foreseeable future”, i.e. the perpetual debt can be considered part of Entity A’s net investment in Entity B. Through the origination of the perpetual debt, Entity A has made a permanent investment in Entity B. The interest payments are treated as interest receivable by Entity A and interest payable by Entity B, not as repayment of the debt principal. Therefore, the fact that the interest payments are perpetual does not mean that settlement is planned or likely to occur.
### Example 3.4.4.1G

**Transaction gains or losses on dividends**

If a foreign subsidiary with a functional currency different from that of its parent declares a dividend to the parent (the legal effect being such that the parent's right to the dividend is established), and there is a significant time lag between the date of recognition of the dividend revenue and the date when cash is received, a translation gain or loss will arise on the parent's dividend receivable account.

IAS 21 does not address the accounting for such gains and losses specifically. However, the receivable is a monetary item and does not meet the criteria to be treated as part of the net investment in the subsidiary (on the basis that payment is expected in the foreseeable future). Accordingly, gains and losses on retranslating the monetary item should be taken to profit or loss by the parent, and should not be reclassified on consolidation of the subsidiary.

This may be contrasted with the exchange gains and losses arising when an interest in a subsidiary is retranslated on consolidation, which are recognised in other comprehensive income (see 4.3.1). IAS 21:41 states that the reason for not recognising such translation adjustments in profit or loss for the period is that the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the foreign entity or the reporting entity. When a dividend has already given rise to an asset in the parent, however, changes in exchange rates have a direct effect on the parent's future cash inflows (see also the discussion in 5.4).

### 3.4.4.2 Exchange differences on monetary items to be recognised outside profit or loss

Certain monetary items are outside the scope of IAS 21 because they are instead dealt with by IFRS 9 or, for entities that have not yet adopted IFRS 9, IAS 39 (e.g. an item designated as a hedging instrument). For monetary items within the scope of IAS 21, however, there is only one exception to the requirement that exchange differences are recognised in profit or loss. When a monetary item forms part of a reporting entity's net investment in a foreign operation (see 3.4.4.1):

**[IAS 21:32]**

- exchange differences are recognised in profit or loss in the separate financial statements of the reporting entity and of the foreign operation, as appropriate; but
- in any financial statements that include both the reporting entity and the foreign operation (e.g. consolidated financial statements if the foreign operation is a subsidiary), such exchange differences are recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment in accordance with IAS 21:48 (see section 6).

The effect of this in the ‘consolidated’ financial statements (i.e. those that combine the reporting entity and the foreign operation) is as follows:

**[IAS 21:33]**

- a monetary item denominated in the functional currency of the reporting entity gives rise to an exchange difference in the foreign operation, and this is recognised in other comprehensive income as above;
- a monetary item denominated in the functional currency of the foreign operation gives rise to an exchange difference in the reporting entity, and this is recognised in other comprehensive income as above; and
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

• a monetary item denominated in a currency other than the functional currency of either the reporting entity or the foreign operation gives rise to an exchange difference in the separate financial statements of both the foreign operation and the reporting entity, and these are recognised in other comprehensive income as above.

3.4.4.3 Changing the form of a long-term investment which forms part of the net investment in a foreign operation

Example 3.4.4.3 Changing the form of a long-term investment which forms part of the net investment in a foreign operation

A UK entity, Company A, has a Canadian subsidiary to which it has made advances that are denominated in Canadian dollars. Company A has previously represented its intention that the advances are a long-term investment. Consequently, exchange gains and losses on the advances have been recognised in other comprehensive income in the consolidated financial statements in accordance with IAS 21:32. There have been no previous repayments of these advances.

As a result of a decline in the Canadian dollar compared to Sterling, the value of the advances has declined. In order to receive a tax deduction in the UK for the decrease, Company A would like to require the Canadian subsidiary to repay the advances. However, Company A does not want to realise a loss on the transaction for accounting purposes. Company A proposes to contribute cash to the Canadian subsidiary in the form of a capital contribution and the Canadian subsidiary will immediately use the cash received to repay the advances.

Does the proposed transaction require Company A to recognise a loss for the elimination of the amount of the cumulative translation adjustment pertaining to the advances?

No. In the proposed transaction, Company A is replacing one form of long-term investment (long-term advances) with another form of long-term investment (capital contribution). The translation adjustment attributable to the long-term intragroup advances should remain as a component of equity until the disposal or partial disposal of the Canadian subsidiary, at which time it should be reclassified from equity to profit or loss as a reclassification adjustment.

3.4.4.4 Change in circumstances so that a monetary item becomes part of the net investment in a foreign operation

An entity may not initially regard an intragroup loan as being part of the net investment in a subsidiary, but circumstances may later change such that it is so regarded. From the date at which the criteria for regarding the loan as part of the parent’s net investment in the subsidiary are met, the changed nature of the loan should be accounted for prospectively, with exchange differences arising after that date taken to a separate component of equity on consolidation, together with those exchange differences arising on retranslation of the net assets and income and expenses of the subsidiary.

In some circumstances, it is necessary to exercise a degree of judgement as to the date from which the criteria are met. Therefore, it is necessary to consider carefully all of the available evidence in arriving at this judgement.

3.4.4.5 Loans or advances from other group entities

The entity that has a monetary item receivable from, or payable to, the foreign operation may be the parent entity or any subsidiary in the group, including another foreign operation. [IAS 21:15A]
For example, an entity has two subsidiaries, A and B. Subsidiary A grants a loan to Subsidiary B. Subsidiary A’s loan receivable from Subsidiary B would be part of the entity’s net investment in Subsidiary B if settlement of the loan is neither planned nor likely to occur in the foreseeable future. [IAS 21:15A]

Therefore, a monetary item for which settlement is neither planned nor likely to occur in the foreseeable future forms part of a reporting entity’s net investment in a foreign operation regardless of whether the monetary item results from a transaction with the reporting entity or any of its subsidiaries (see IAS 21:BC25E).

3.4.4.6 Loans or advances denominated in another currency

Most frequently, a monetary item that forms part of a reporting entity’s net investment in a foreign operation under IAS 21:15 and 15A is denominated in the functional currency of the foreign operation or alternatively in the functional currency of the reporting entity. However, it may be denominated in a currency other than the functional currency of either entity. For example, the monetary item may be denominated in a currency that is more readily convertible than the local domestic currency of the foreign operation.

IAS 21:33 is clear that foreign exchange differences on a monetary item denominated in a currency other than the functional currency of either the reporting entity or the foreign operation also qualify for initial recognition in other comprehensive income in the consolidated financial statements, provided that the criteria in IAS 21:15 and 15A are met.

IAS 21:BC25E also confirms that a monetary item for which settlement is neither planned nor likely to occur in the foreseeable future forms part of a reporting entity’s net investment in a foreign operation regardless of the currency of the monetary item.

3.5 Reporting foreign currency items at the end of subsequent reporting periods — non-monetary items

3.5.1 Non-monetary items measured in terms of historical cost

The carrying amount of non-monetary items at the end of subsequent reporting periods is determined in conjunction with other relevant IFRSs.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the spot exchange rate at the date of the transaction, i.e. they remain at the initial recognised amount and are not retranslated. [IAS 21:23(b)] These balances reflect the historical cost in the functional currency of acquiring the items.
Example 3.5.1
Non-monetary item measured at historical cost

Company T, whose functional currency is the Euro, has not yet adopted IFRS 9 Financial Instruments. It holds an investment in a Japanese entity. The investment is accounted for appropriately under IAS 39:46(c) at cost because it does not have a quoted market price in an active market and its fair value cannot be reliably measured. Company T's initial investment was made in Japanese yen and represented 4.3 million Euro at the date of acquisition of the investment. At the end of the reporting period, the historical cost in Japanese yen, if translated at the closing rate, would correspond to 6 million Euro.

It would not be appropriate to recognise the 1.7 million Euro increase as a translation gain. IAS 21:23 states that non-monetary items denominated in a foreign currency measured in terms of historical cost should be reported using the exchange rate at the date of the transaction. Accordingly, the investment should continue to be measured at 4.3 million Euro.

3.5.2 Non-monetary items measured at fair value

Non-monetary items that are measured at fair value in a foreign currency are translated using the spot exchange rates at the date when the value was measured. [IAS 21:23(c)]

3.5.3 Carrying amount of non-monetary item determined by comparing two or more amounts

Sometimes the carrying amount of an item is determined by comparing two or more amounts, for example:

- the lower of cost and net realisable value for inventories (IAS 2 Inventories); or
- the lower of an asset's previous carrying amount and its recoverable amount to determine the amount of an impairment loss (IAS 36 Impairment of Assets).

When the asset is non-monetary and is measured in a foreign currency, the carrying amount is determined as the lower of:

[IAS 21:25]

- the cost or carrying amount translated at the exchange rate at the date that amount was determined (the rate at the transaction date for items carried at historical cost); and
- the net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date that value was determined. This will be the closing rate if the value was determined at the end of the reporting period.

The effect of this may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency, or vice versa.
Example 3.5.3

Determining net realisable value for inventories

Company A is a UK entity, and has Sterling as its functional currency.

Company A purchases inventories for €150 when the exchange rate is £1:€1.50. Company A plans to sell the inventories in Euro.

At the end of the reporting period, the exchange rate is £1:€1.20. The inventories are slightly damaged and Company A determines the net realisable value (NRV) to be €120.

How should Company A determine the Sterling carrying amount of the inventories at the end of the reporting period?

The carrying amount at the end of the reporting period (i.e. the lower of cost and NRV) is determined by comparing:

- cost of €150 translated at the transaction date rate of £1:€1.50; with
- NRV of €120 translated at the closing rate of £1:€1.20.

These are both £100, so there is no write-down of inventories in the financial statements at the end of the reporting period.

When measuring NRV, the currency in which the inventories will be sold is used. For Company A, this is Euro. In the circumstances described, at the end of the reporting period, the inventories are impaired in Euro (by €30) but not in Sterling, because the exchange rate has moved. Consequently, no impairment is recognised in Company A’s financial statements.

3.5.4 Recognition of exchange differences on non-monetary items

3.5.4.1 Recognition of exchange differences on non-monetary items – general

When a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss is also recognised in profit or loss. When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange component of that gain or loss is also recognised in other comprehensive income. [IAS 21:30]

For example, IAS 16 Property, Plant and Equipment requires some gains and losses arising on a revaluation of property, plant and equipment to be recognised in other comprehensive income. When such an asset is measured in a foreign currency, IAS 21:23(c) requires the revalued amount to be translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognised in other comprehensive income. [IAS 21:31]

Example 3.5.4.1

Non-monetary asset measured at fair value in a foreign currency

On 1 November 20X1, Company A (Sterling functional currency) buys a building to be used as its new head office for US$50,000,000, with full payment being made on that date. The exchange rate is US$1.68:£1. At the end of Company A’s reporting period, 31 December 20X1, the building is not depreciated because it is not yet available for use. The exchange rate is US$1.71:£1 and the fair value of the building is US$60,000,000 at that date.
### Example 3.5.4.1
Non-monetary asset measured at fair value in a foreign currency (continued)

The journal entries are as follows.

1 November 20X1

<table>
<thead>
<tr>
<th></th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Property, plant and equipment</td>
<td>29,761,905</td>
<td></td>
</tr>
<tr>
<td>Cr Cash</td>
<td></td>
<td>29,761,905</td>
</tr>
</tbody>
</table>

*To recognise the US$ transaction in the functional currency at the exchange rate at the time of the transaction of US$1.68:£1.*

Depending on whether Company A accounts for its owner-occupied buildings at cost (less accumulated depreciation and impairment losses), or at a revalued amount, subsequent accounting entries are as follows.

**At cost (less accumulated depreciation and impairment losses)**

31 December 20X1

The building is a non-monetary item and held at historical cost. It continues to be measured at £29,761,905 (i.e. at the transaction rate).

**At revalued amount**

31 December 20X1

The building is a non-monetary item and held at fair value. It is retranslated at the rate of exchange at the date of valuation.

<table>
<thead>
<tr>
<th></th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Property, plant and equipment</td>
<td>5,325,814</td>
<td></td>
</tr>
<tr>
<td>Cr Revaluation gain (other comprehensive income)</td>
<td></td>
<td>5,325,814</td>
</tr>
</tbody>
</table>

*To recognise a gain in fair value of £5,325,814 (£35,087,719 – £29,761,905), which includes the exchange component.*

Note that when an asset’s revalued amount is less than its carrying amount, and no credit balance exists in the revaluation surplus in respect of the asset, an expense is recognised in profit or loss.
3.5.4.2 Foreign-currency denominated available-for-sale financial assets (for entities that have not yet adopted IFRS 9)

In accordance with IAS 39, available-for-sale financial assets are measured at fair value with fair value gains or losses recognised in other comprehensive income and reclassified from equity to profit or loss when the asset is derecognised or impaired (see 3.1.4 in chapter C6).

For the purpose of recognising foreign exchange gains and losses in respect of available-for-sale financial assets that are monetary items, IAS 39:AG83 requires that such items be treated as if they are carried at amortised cost in the foreign currency. Therefore, exchange differences resulting from changes in amortised cost are recognised in profit or loss, with other changes in the carrying amount recognised in other comprehensive income in accordance with IAS 39:55(b).

This treatment results in the cumulative gain or loss recognised in other comprehensive income being the difference between the amortised cost (adjusted for impairment, if any) and the fair value of the instrument in the functional currency of the reporting entity. The approach is illustrated in a numerical example (IAS 39:IG.E.3.2) – which is reproduced as example 3.3.4 in chapter C6.

For non-monetary available-for-sale financial assets (e.g. equity investments), the gain or loss that is recognised in other comprehensive income includes any related foreign currency component.

3.6 Exchange rates — other considerations

3.6.1 Several exchange rates available

In some circumstances, there may be several exchange rates available (e.g. when a country is experiencing turmoil and its government has imposed an exchange rate that is different from the spot exchange rate in order to discourage the outflow of capital from that country).

When several exchange rates are available, the rate to be used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. [IAS 21:26]

3.6.2 Unofficial exchange rate for translation and remeasurement

When there is both an official exchange rate and an unofficial exchange rate, and the unofficial exchange rate is used both widely and legally for the purposes of currency conversions, a parallel or dual exchange rate situation exists.

In such circumstances, if it can be demonstrated reasonably that transactions have been or will be settled at the unofficial rate (including currency exchanges for dividend or profit repatriations), it is appropriate to use the unofficial rate for translation and remeasurement purposes.
Example 3.6.2
Dividend remittance rate specified by government

A country is experiencing economic turmoil, and the government has imposed an exchange rate different from the spot market exchange rate in order to discourage capital from leaving the country. The new rate is the dividend remittance rate. This specific exchange rate applies to all remittances of earnings or dividends distributed outside the country.

Which rate should be used by a parent in translating a subsidiary operating in such a foreign country?

IAS 21:8 defines the closing rate as “the spot exchange rate at the end of the reporting period”. The closing rate should be the rate the entity currently would pay or receive in the market. Therefore, in the circumstances described, the dividend remittance rate would be appropriate for translation purposes because cash flows to the reporting entity can only occur at this rate, and the realisation of a net investment is dependent upon cash flows from that foreign entity.

Unusual circumstances that may permit an entity to use the market exchange rate in translating a foreign subsidiary in the circumstances described above would include (1) a history of obtaining the market exchange rate for such transactions, and (2) the ability to source funds at the market exchange rate. Otherwise, the dividend remittance rate should be used.

Careful judgement should be applied to determine whether circumstances such as those described result in loss of control of the foreign subsidiary (see section 12 in chapter A24).

3.6.3 Lack of exchangeability between two currencies

When exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made. [IAS 21:26]

3.6.4 Exchange rate movements after the end of the reporting period

Example 3.6.4
Exchange rate movements after the end of the reporting period

Company G is a German entity with a Russian subsidiary. The subsidiary's functional currency is the Russian ruble. The subsidiary has Euro-denominated debt. The Russian ruble exchange rate against the Euro has fluctuated significantly in the two months before and after the end of the reporting period.

IAS 21:23(a) states that foreign currency monetary items should be reported at the end of each reporting period using the closing rate, with no exceptions specified. It would not be appropriate to use an exchange rate subsequent to the end of the reporting period, even though exchange rates are volatile.

Due to the significant volatility in exchange rates, however, the effect on foreign currency monetary items of a change in exchange rates occurring after the end of the reporting period should be disclosed in accordance with IAS 10 Events after the Reporting Period if the change is of such significance that non-disclosure would affect the ability of users of the financial statements to make proper evaluations and decisions (see 7.1 in chapter A22).

3.7 Accounting records in a currency other than the functional currency

When an entity keeps its accounting records in a currency other than its functional currency, at the time the entity prepares its financial statements all amounts are translated into the functional currency in accordance with IAS 21.20 to 26, so as to produce the same amounts in the functional currency as would have occurred had the items been recognised initially in the functional currency. [IAS 21:34]
4 Presentation currency

4.1 Presentation currency — definition

The presentation currency is defined as the currency in which the financial statements are presented. [IAS 21:8] Unlike an entity's functional currency, the presentation currency can be any currency of choice. This choice is available both in the entity's 'main' financial statements and, if prepared, any separate financial statements. [IAS 21:19]

An entity normally presents its financial statements in the same currency as its functional currency; however, an entity may choose to present its financial statements in a different currency. Presenting the financial statements in a currency other than the functional currency does not change the way in which the underlying items are measured. It merely expresses the underlying amounts, which are measured in the functional currency, in a different currency.

4.2 Choice of presentation currency

The most common use of a presentation currency is in the context of a consolidated group. When a group contains entities with different functional currencies, the results and financial position of each entity must be expressed in a common currency in order to produce the consolidated financial statements. The presentation currency of the consolidated financial statements of the group is often, but not always, the functional currency of the parent.

A corporate group may have extensive operations in many countries and conduct its business largely in international markets. It may be difficult to identify the most appropriate presentation currency. An international currency such as Sterling, the US dollar or the Euro might be used. For example, for entities that raise capital in international markets, the use of an international currency may be of benefit to the users of the financial statements.

Individual entities, or groups where all of the entities have the same functional currency, may also choose to present their financial statements in a currency other than their functional currency. This option may be selected, for example:

- to provide information to overseas shareholders; or
- for the purpose of preparing statutory financial statements in some jurisdictions where entities are required to present their financial statements in the local currency even if this is not their functional currency; or
- by a subsidiary that wishes to present its financial statements in the functional currency of its parent when that is different from its own functional currency.
4.3 Translation to a presentation currency

4.3.1 Translation to a presentation currency — general

Except when the functional currency is the currency of a hyperinflationary economy (see 4.4), an entity’s results and financial position are translated from its functional currency into a different presentation currency using the following procedures:

[IAS 21:39]

(a) assets and liabilities for each statement of financial position presented (i.e. including comparative amounts) are translated at the closing rate at the date of that statement of financial position;

(b) for each period presented (i.e. including comparative periods), income and expenses recognised in the period are translated at the exchange rates at the dates of the transactions; and

(c) all resulting exchange differences are recognised in other comprehensive income.

Cash flows are translated on a basis similar to that required for income and expenses, i.e. using the exchange rates at the transaction dates (see paragraphs 25 and 26 of IAS 7 Statement of Cash Flows). Equity transactions (e.g. contributions to equity share capital, distributions to owners of equity) are also translated at the exchange rates at the transaction dates.

For practical reasons, a rate that approximates the exchange rates at the dates of the transactions (e.g. an average rate for the period) is often used to translate income and expense items in step (b) above. If exchange rates fluctuate significantly, however, the use of the average rate for a period is inappropriate. [IAS 21:40]

4.3.2 Recognition of exchange differences arising on translation to a presentation currency

IAS 21:41 explains that exchange differences resulting from translation into a presentation currency are not recognised in profit or loss because those changes in exchange rates have little or no direct effect on the present and future cash flows from operations.

The exchange differences arising on translation to the presentation currency result from:

[IAS 21:41]

- translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate; and

- translating the opening net assets at an exchange rate (closing rate) different from that at which they were previously reported.

The cumulative amount of the exchange differences is presented in a separate component of equity until disposal of the foreign operation (see section 6). [IAS 21:41]
As set out in 4.3.1, IAS 21:39 provides rules for the translation of income, expenses, assets and liabilities; however, it does not refer to the translation, or retranslation, of share capital or other equity reserves. IAS 21:39(c) requires that exchange differences arising from translation should be recognised in other comprehensive income and later reclassified to profit or loss on disposal or partial disposal; those amounts do not reflect any retranslation of share capital or other equity reserves. Accordingly, the ‘foreign currency translation reserve’ should not include any amounts for the retranslation of share capital or other equity reserves.

Although IAS 21 does not specifically prohibit the retranslation of share capital and other equity reserves, such a retranslation would have no meaning for financial reporting purposes, because any ‘differences’ arising would never be reclassified to profit or loss.

Accordingly, it is generally considered most meaningful to translate share capital and other components of equity using the historical rate, i.e. the exchange rate at the date of issue of share capital, or at the date of the associated transaction for other equity reserves. In particular, if this approach is adopted:

- when translating share capital into the presentation currency, the rate at the date of issue would be used. Thus, more than one historical rate will apply when share capital is issued at different times; and
- when translating a revaluation reserve (e.g. when an item of property is revalued in accordance with IAS 16 Property, Plant and Equipment) into the presentation currency, the rate at the date of each revaluation would be used. Thus, more than one historical rate will apply when a revaluation reserve relates to assets that have been revalued at different times.

4.4 Translation to the presentation currency from the currency of a hyperinflationary economy

When an entity’s functional currency is the currency of a hyperinflationary economy, the entity must first restate its financial statements in accordance with IAS 29 Financial Reporting in Hyperinflationary Economies before translating its results into its chosen presentation currency (see chapter A37). Note, however, that the treatment of comparative amounts translated into the currency of a non-hyperinflationary economy is different, as discussed below. [IAS 21:43]

Once the entity’s financial statements have been restated in accordance with IAS 29, if the entity chooses to present them in a different presentation currency, the results and financial position of that entity are translated into a different presentation currency as follows:

[IAS 21:42]

- all amounts (i.e. assets, liabilities, equity items, income and expenses, including comparative amounts) are translated at the closing rate at the date of the statement of financial position; except that
- when comparative amounts are translated into the currency of a non-hyperinflationary economy, all amounts are those presented in the prior financial statements (i.e. they are not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).
Note that the different treatment of comparative amounts described above does not apply when the presentation currency is that of a (different) hyperinflationary economy. In those circumstances, all amounts are translated at the closing rate of the most recent statement of financial position presented (i.e. last year’s comparative amounts, as adjusted for subsequent changes in the price level, are translated at this year’s closing rate).

When the economy ceases to be hyperinflationary and the entity no longer restates its financial statements in accordance with IAS 29, it uses as the historical costs for translation into the presentation currency the amounts restated to the price level at the date the entity ceased restating its financial statements. [IAS 21:43]

**Example 4.4**

**Comparative amounts in the consolidated financial statements of a parent when the economy of the functional currency of a subsidiary becomes hyperinflationary in the current reporting period**

In 20X9, Subsidiary A’s functional currency is determined to be that of a hyperinflationary currency. As required by IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies, the comparative amounts in Subsidiary A’s financial statements are retrospectively restated as if the subsidiary’s functional currency had always been that of a hyperinflationary currency. The presentation currency of the consolidated financial statements in which Subsidiary A is included is not that of a hyperinflationary economy.

*Should the comparative amounts relating to Subsidiary A in the 20X9 consolidated financial statements of its parent be restated?*

No. IAS 21:42 (see above) describes the procedures for the translation of a foreign operation whose functional currency is the currency of a hyperinflationary economy. IAS 21:42(b) specifies that “when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (i.e not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).”

Therefore, in the circumstances described, the comparative amounts relating to Subsidiary A in the 20X9 consolidated financial statements should not be restated. Only the current period amounts reported in the consolidated financial statements will be affected by Subsidiary A’s accounting under IAS 29.

**4.5 Translation from a non-hyperinflationary functional currency into a hyperinflationary presentation currency**

**Example 4.5**

**Translation from a non-hyperinflationary functional currency into a hyperinflationary presentation currency**

Entity A is located in a jurisdiction with a hyperinflationary economy. Entity A has determined that its functional currency is the currency of a non-hyperinflationary economy. However, due to local regulations, Entity A must present its financial statements in its local currency (i.e. in the currency of a hyperinflationary economy).

*How should Entity A’s financial statements be translated into its hyperinflationary presentation currency?*

Because Entity A’s functional currency is not the currency of a hyperinflationary economy, Entity A is outside the scope of IAS 29 Financial Reporting in Hyperinflationary Economies (see IAS 29:1).

Accordingly, in order to translate its financial statements to the hyperinflationary presentation currency, Entity A must use the following method described in IAS 21:39:

- assets and liabilities for each statement of financial position should be translated at the closing rate of the date of that statement of financial position;
- income and expenses should be translated at the exchange rates at the dates of the relevant transactions; and
- all resulting exchange differences should be recognised in other comprehensive income.
5 Translation of a foreign operation

5.1 Foreign operation — definition
A foreign operation is an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity. [IAS 21:8]

The definition of a foreign operation includes a branch of a reporting entity and it is clear from IAS 21 that it is possible for such a branch to have a different functional currency from that of the entity itself. It follows, therefore, that a single legal entity may consist of several operations with different functional currencies. But, in practice, this will not be common and will arise primarily when branches are largely autonomous and have been combined as a single legal entity for tax or similar reasons.

5.2 General requirements for the translation of a foreign operation
In addition to the procedures discussed in section 4, there are other rules in IAS 21 that apply when the results and financial position of a foreign operation are translated into a presentation currency for inclusion in the financial statements of a reporting entity, whether by consolidation or the equity method. [IAS 21:44] These rules deal with:

- exchange differences attributable to non-controlling interests (see 5.3);
- exchange differences on intragroup transactions (see 5.4);
- financial statements of foreign operations prepared to a different date (see 5.5); and
- goodwill and fair value adjustments (see 5.6).

The incorporation of the results and financial position of a foreign operation in the financial statements of a reporting entity follows normal consolidation procedures as set out in IFRS 10 Consolidated Financial Statements, IAS 28 Investments in Associates and Joint Ventures and IFRS 11 Joint Arrangements. [IAS 21:45] These Standards are discussed in chapters A24, A26 and A27, respectively.

5.3 Exchange differences attributable to non-controlling interests
When a foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognised as part of, non-controlling interests in the consolidated statement of financial position. [IAS 21:41]

5.4 Exchange differences on intragroup transactions
An intragroup monetary asset (or liability), whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability (or asset) without showing exchange differences in the consolidated financial statements.

The monetary item represents a commitment to convert one currency into another and, consequently, the entity is exposed to an exchange gain or loss.

Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference is recognised in profit or loss unless it is a monetary item that forms part of the reporting entity's net investment in the foreign operation – see 3.4.4. [IAS 21:45]
Example 5.4
Exchange gain or loss on intragroup loan

A UK parent, Company X, has a wholly-owned subsidiary in the US, Company Y. Company X's functional currency is Sterling and Company Y's is US dollars. Company X has provided a loan in Sterling to Company Y. The loan is not regarded as part of Company X's net investment in Company Y.

No exchange difference arises in the separate financial statements of the UK parent because the loan receivable is denominated in Company X's functional currency. In the subsidiary's separate financial statements, the loan payable is a monetary item and exchange differences arising on retranslation into Company Y's functional currency of US dollars are recognised in profit or loss in accordance with IAS 21:32.

On consolidation, although the intragroup loan is eliminated from the statement of financial position, the related exchange gain or loss recognised in Company Y's separate financial statements in respect of the Sterling loan payable survives the consolidation process, so that the gain or loss is also recognised in consolidated profit or loss.

Similar logic will apply when Company X has an unsettled balance with Company Y in respect of a recognised dividend receivable. The dividend receivable is a monetary item and must be retranslated into Sterling with foreign exchange gains or losses recognised in profit or loss.

See 3.4.4.4 for a discussion of the accounting implications when changes in circumstances result in an entity regarding a pre-existing intragroup loan as becoming part of the net investment in a subsidiary.

5.5 Financial statements of a foreign operation prepared to a different date

A foreign operation may prepare financial statements to a date different from that of the reporting entity, e.g. for tax reasons or if legislation in its country requires financial statements to be prepared to a specific date. Often the foreign operation will prepare additional statements to the same date as those of the reporting entity (investor) for inclusion in the consolidated financial statements.

When it is impracticable to prepare additional statements, IFRS 10 Consolidated Financial Statements allows the use of a different date, provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates.

If the foreign operation's financial statements are prepared to a different date, the assets and liabilities of the foreign operation are translated at the exchange rate at that date (i.e. at the end of the reporting period of the foreign operation). In accordance with IFRS 10, adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity. For example, significant movements may arise between the two dates if the functional currency of the foreign operation devalues significantly against that of the reporting entity. [IAS 21:46]
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

Example 5.5
Financial statements of a foreign operation prepared to a different date

A parent includes a foreign subsidiary’s financial statements for the year ended 30 November in the parent’s consolidated financial statements for the year ended 31 December. Between 30 November and 31 December, the functional currency of the subsidiary devalues significantly against the parent’s functional currency (which is also the presentation currency of the group).

When the financial statements of a subsidiary used in the consolidated financial statements are prepared to a date different from that of the parent, IFRS 10 requires adjustments to be made for the effects of significant events or transactions that occur between that date and the date of the parent’s financial statements. The rate used for the translation of the foreign subsidiary’s financial statements should be the spot rate at 30 November, as required by IAS 21:46, but, separately, it is necessary to consider which assets and liabilities might be affected significantly by the devaluation. Different items may be affected in different ways. For example:

- a further adjustment may be required for significant non-monetary assets of the subsidiary to retranslate them using the rate at 31 December, with a corresponding adjustment to the exchange differences recognised in other comprehensive income;
- conversely, for any significant monetary assets of the subsidiary that are denominated in the functional currency of the parent, there may be little impact on the consolidated statement of financial position. However, a further adjustment may be required to recognise in profit or loss the exchange gains that arose on those items in the subsidiary during December, with a corresponding adjustment to the exchange differences recognised in other comprehensive income.

The same approach is used in applying the equity method to associates and joint ventures in accordance with IAS 28 Investments in Associates and Joint Ventures. [IAS 21:46]

5.6 Goodwill and fair value adjustments

5.6.1 Goodwill and fair value adjustments — general

Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation are:

[IAS 21:47]

- treated as assets and liabilities of the foreign operation, and therefore expressed in the functional currency of the foreign operation; and
- translated at the closing rate in accordance with IAS 21:39 and IAS 21:42.

The level at which goodwill is allocated for functional currency purposes (see 5.6.2) may differ from the level at which goodwill is tested for impairment in accordance with IAS 36 Impairment of Assets (see 8.2.8 in chapter A10).
## 5.6.2 Interaction between IAS 21 and IAS 36

### Example 5.6.2A
Allocation of goodwill arising from the acquisition of a foreign operation

Company A, a French entity with the Euro as its functional currency, acquires Company S, a Swiss entity. Following the acquisition, the functional currency of Company S continues to be the Swiss franc (CHF).

One of Company A's other subsidiaries, Company D (also located in France with the Euro (€) as its functional currency) is expected to benefit from the synergies of the acquisition. Company D represents a cash-generating unit (CGU) as defined in IAS 36:6. Consequently, in accordance with IAS 36:80, part of the goodwill arising on the acquisition of Company S is allocated to Company D's CGU for the purposes of impairment testing.

Should the goodwill allocated to Company D be considered a Swiss franc or a Euro-denominated asset going forward? At what rate should the goodwill allocated to Company D be converted for the purposes of preparing the consolidated financial statements of Entity A and performing goodwill impairment tests?

The goodwill allocated to Company D is a Euro-denominated asset.

IAS 21:BC31 states that “goodwill arises only because of the investment in the foreign entity and has no existence apart from that entity. . . . [W]hen the acquired entity comprises a number of businesses with different functional currencies, the cash flows that support the continued recognition of goodwill are generated in those different functional currencies”.

While one would generally expect that the ‘foreign’ operation supporting the continued recognition of goodwill is part of the foreign operation acquired, this is not always the case. In allocating a portion of the goodwill to Company D, Company A has determined that it is the cash flows of a CGU with a Euro functional currency (Company D), rather than those of the Swiss entity, that will support the continued recognition of the goodwill. Therefore, goodwill should be treated as an asset of Company D for the purposes of IAS 21:47.

The goodwill allocated to Company D should be translated at the rate in effect on the date of its allocation to Company D (i.e. the date of acquisition).

### Example 5.6.2B
Reallocation of goodwill to a foreign operation

Company A, a French entity with the Euro as its functional currency, acquires Company B, a UK entity (functional currency Sterling). In accordance with IAS 36:80, the goodwill arising on the acquisition is allocated to Company A's various UK operations (including Company B) that are expected to primarily benefit from the synergies of the combination. In accordance with IAS 21:47, the goodwill is considered a Sterling asset and is translated at the closing rate.

Several years later, Company A undertakes an internal reorganisation and some of the UK operations are transferred to France. In accordance with IAS 36:87, Company A reallocates a portion of the goodwill originally generated on the acquisition of Company B to its French operations using a relative value approach.
Example 5.6.2B
Reallocation of goodwill to a foreign operation (continued)

Following this reorganisation, should the portion of the goodwill reallocated to the French operations be considered a Sterling or a Euro-denominated asset going forward? At what rate should that portion of goodwill be converted for the purposes of preparing the consolidated financial statements of Entity A and performing goodwill impairment tests?

In allocating a portion of the goodwill to operations with a Euro functional currency, Company A has determined that it is the cash flows of its French operations that will support the continued recognition of that portion of the goodwill following the reorganisation. Therefore, that portion of the goodwill should be treated as an asset of the French operations and should be converted from Sterling at the rate in effect on the date of the reallocation (in this case on the date of the internal reorganisation) to determine the Euro carrying amount going forward.

5.7 Multi-level consolidations

Example 5.7
Multi-level consolidation

A Swiss parent wholly owns a second-tier German subsidiary. The German subsidiary wholly owns a third-tier British subsidiary. The local currency is the functional currency for all entities, and the presentation currency of the consolidated entity is the Swiss franc. Each entity has third-party foreign-currency-denominated debt.

Under IAS 21, what is the appropriate accounting for the foreign-currency transactions and the foreign-currency financial statements in the consolidation of the subsidiaries with the Swiss parent?

The British and German subsidiaries recognise translation gains and losses on their respective third-party foreign-currency-denominated debt in their individual or separate financial statements using the closing rate at the end of the reporting period in accordance with IAS 21:23. The translation gains and losses are recognised in profit or loss and are not reversed out of profit or loss on consolidation.

In its separate financial statements, the Swiss parent recognises translation gains and losses on its third-party foreign-currency-denominated debt in profit or loss, just as its subsidiaries do for their foreign-currency-denominated debt.

If an intermediate consolidation exercise is performed, the German subsidiary translates the British subsidiary’s Sterling-denominated financial statements into Euro-denominated financial statements. The Sterling-to-Euro exchange differences are recognised in other comprehensive income in the intermediate consolidated financial statements. The Swiss parent then translates the Euro-denominated, consolidated financial statements of the German subsidiary into Swiss francs and recognises the resulting exchange differences in other comprehensive income in the ultimate consolidated financial statements.

If an intermediate consolidation exercise is not performed, the Swiss parent translates the Sterling-denominated financial statements of the British subsidiary and the Euro-denominated financial statements of the German subsidiary into Swiss francs. The exchange differences arising are recognised in other comprehensive income.
IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* notes that the aggregate net amount recognised in the foreign currency translation reserve in respect of all foreign operations is not affected by whether the ultimate parent uses the direct or the step-by-step method of consolidation. IFRIC 16 is discussed at 6.6 in chapter B9 (or, for entities that have not yet adopted IFRS 9 *Financial Instruments*, 2.3 in chapter C9).

### 5.8 Change in both presentation and functional currencies

**Example 5.8** Change in both presentation and functional currencies

Company A is preparing its financial statements for the year ended 31 December 20X8. In the previous reporting period ended 31 December 20X7, the Euro was both the functional currency and the presentation currency of Company A.

With effect from 1 January 20X8, because of changes in trading arrangements that meet the requirements of IAS 21:36, the functional currency of Company A is changed to the US dollar (US$). In accordance with IAS 21:37 (see 3.2.8.2), Company A applies the new functional currency prospectively from 1 January 20X8.

In addition, Company A chooses to change its presentation currency from the Euro to US$ for the period ended 31 December 20X8.

Should the change in presentation currency be viewed as a change in accounting policy to be applied retrospectively?

If so, which Euro/US$ exchange rate should be applied to:

- the assets and liabilities of Company A at 31 December 20X7;
- the statement of comprehensive income of Company A for the reporting period ended 31 December 20X7; and
- the opening equity of Company A at 1 January 20X7?

Unlike its functional currency, an entity's presentation currency can be any currency of choice. Therefore, the change in the presentation currency is a change in accounting policy and, as a consequence, should be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This contrasts with the change in functional currency that, in accordance with IAS 21:37, is accounted for prospectively from the date of the change.

Therefore, in the financial statements of Company A for the year ended 31 December 20X8:

- for the 20X8 (current) period, US$ is both the functional and the presentation currency, whereas
- for the 20X7 (comparative) period, the functional currency remains the Euro and the presentation currency is restated to US$.

A retrospective change in presentation currency to US$ gives the same result as if the presentation currency had always been US$. This is achieved by applying the following rates of exchange:

- for the assets and liabilities of Company A at 31 December 20X7, the closing exchange rate at that date;
- for the statement of comprehensive income of Company A for the reporting period ended 31 December 20X7, the exchange rates at the dates of the transactions or, if it offers a reasonable approximation, the average rate for the period; and
- for the opening equity of Company A at 1 January 20X7, the historical rate (i.e. the rate at the date of issue of each equity instrument and average rate for each period in which retained earnings arose).

The 20X8 financial statements will therefore include an exchange reserve in the comparative period, to reflect the fact that the presentation currency (US$) differs from the functional currency (Euro) in that period. This exchange reserve is retained in the 20X8 period and in subsequent periods, regardless of the fact that from 1 January 20X8 the presentation currency is the same as the functional currency.
Example 5.8
Change in both presentation and functional currencies (continued)

The following detailed workings illustrate these principles.

In its 20X7 financial statements, when the Euro was both the functional and the presentation currency, Company A reported the following amounts.

<table>
<thead>
<tr>
<th>20X7 Statement of financial position (€)</th>
<th>20X7 Income statement (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Share capital</strong></td>
</tr>
<tr>
<td>1,000</td>
<td>180</td>
</tr>
<tr>
<td>20</td>
<td>Retained earnings(a)</td>
</tr>
<tr>
<td>800</td>
<td>Liabilities</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,000</strong></td>
</tr>
</tbody>
</table>

(a) For simplicity, this example assumes that the only movement in retained earnings since the inception of Company A is the profit for the year 20X7; in practice, historical retained earnings for each period would have to be translated at the average exchange rate for that period.

The relevant exchange rates are as follows.

<table>
<thead>
<tr>
<th>31/12/20X6</th>
<th>Average 20X7</th>
<th>31/12/20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>€/US$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.40</td>
<td>1.37</td>
<td>1.47</td>
</tr>
</tbody>
</table>

At the date of issue of the share capital of Company A (in 20X0), the Euro/US dollar (US$) exchange rate was 1.60.

Company A is required to perform the following steps to reflect the changes in functional and presentation currencies in its 20X8 financial statements.

1. **Restate comparative reporting period (20X7) to US$ presentation currency**

The statement of financial position and statement of profit or loss (income statement) for the comparative period (20X7) are restated as follows.

<table>
<thead>
<tr>
<th>20X7 Statement of financial position (US$)</th>
<th>20X7 Income statement (US$)(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Share capital</strong></td>
</tr>
<tr>
<td>1,470</td>
<td>288</td>
</tr>
<tr>
<td>(21) Exchange reserve(d)</td>
<td>27</td>
</tr>
<tr>
<td>1,176</td>
<td>Liabilities(e)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,470</strong></td>
</tr>
</tbody>
</table>

(a) Figures translated from Euro to US$ using the closing exchange rate at 31/12/20X7 of 1.47.
(b) Figures translated from Euro to US$ using the average 20X7 exchange rate of 1.37.
(c) Equity (share capital in this scenario) translated from Euro to US$ using the historical exchange rate at the date of issue of 1.60.
(d) The exchange reserve represents the sum of (1) the difference between the net assets at the end of 20X6 (Euro180) translated at the historical exchange rate, in this case at the date of issue of the share capital, (US$288) and the closing 20X6 exchange rate (US$252), and (2) the difference between the opening net assets at opening exchange rate (US$252) plus profit for the year at average exchange rate (US$27) and the closing net assets at closing exchange rate (US$294). The total in (2) (a credit of US$15) is recognised as an item of other comprehensive income.
(e) Retained earnings will be each year's profit at the average exchange rate for the year.
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

Example 5.8
Change in both presentation and functional currencies (continued)

2. Change to US$ functional currency in current reporting period (20X8)

Assume that Company A earns revenue of US$130 and incurs expenses of US$70 during 20X8 and that assets increase to US$1,654 and liabilities to US$1,300. The statement of financial position and the statement of profit or loss (income statement) for the current reporting period (20X8) are as follows.

<table>
<thead>
<tr>
<th>20X8 Statement of financial position (US$)</th>
<th>20X8 Income statement (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Revenue</td>
</tr>
<tr>
<td>1,654</td>
<td>130</td>
</tr>
<tr>
<td>288 Share capital&lt;sup&gt;(a)&lt;/sup&gt;</td>
<td>70</td>
</tr>
<tr>
<td>87 Retained earnings&lt;sup&gt;(b)&lt;/sup&gt;</td>
<td>60</td>
</tr>
<tr>
<td>(21) Exchange reserve&lt;sup&gt;(c)&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>1,300 Liabilities</td>
<td>130</td>
</tr>
<tr>
<td>1,654</td>
<td>130</td>
</tr>
</tbody>
</table>

<sup>(a)</sup> Equity (share capital in this scenario) translated from Euro to US$ using the historical exchange rate at the date of issue.

<sup>(b)</sup> Retained earnings made up of profit of US$60 for the current period plus profit from each of the previous periods of US$27.

<sup>(c)</sup> The exchange reserve reported in 20X7 is retained in 20X8 (and in future accounting periods), regardless of the fact that from 1 January 20X8 the functional currency of Company A is the same as its presentation currency.

6 Disposal or partial disposal of a foreign operation

6.1 Transactions or events giving rise to a disposal or a partial disposal

An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all, or part, of that entity. [IAS 21:49]

Disposals and partial disposals can arise directly or indirectly. For example, an entity's ownership interest could be reduced by the entity selling shares to a third party, through the entity choosing not to participate in a rights issue by the investee, or by the investee repurchasing equity shares from the entity but not from other investors.

6.2 Transactions or events accounted for as a 'disposal'

In addition to the disposal of an entity's entire interest in a foreign operation, the following partial disposals are accounted for as disposals:

[IAS 21:48A]

- when the partial disposal involves the loss of control of a subsidiary that includes a foreign operation, regardless of whether the entity retains a non-controlling interest in its former subsidiary after the partial disposal; and
- when the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes a foreign operation.
IAS 21 specifies different accounting for exchange differences accumulated in equity for ‘disposals’ and ‘partial disposals’. A disposal of a foreign operation can occur either when the foreign operation is disposed of in its entirety or in one of the additional circumstances set out in IAS 21:48A when the disposal of a partial interest is accounted for as a ‘full’ disposal.

The following events are accounted for as partial disposals rather than disposals:

- the loss of joint control over a joint arrangement that includes a foreign operation, but the retention of an ongoing interest in that entity that is accounted for as an associate; and
- the less common scenario in which the disposal of part of an associate that includes a foreign operation results in the loss of significant influence but the retention of an ongoing interest in that entity that is accounted for as a joint arrangement.

Example 6.2 illustrates the accounting for a disposal of a partial interest that is accounted for as a full disposal.

**Example 6.2**

**Loss of control of a wholly-owned foreign operation**

A parent, Company P, has held a 100 per cent interest in a subsidiary, Company S, for a number of years. Company S is a foreign operation and, in accordance with IAS 21:39, exchange differences of CU2.5 million relating to Company S have been recognised in other comprehensive income and accumulated in a separate component of equity.

Company P disposes of 51 per cent of its interest in Company S, resulting in loss of control. Its retained interest of 49 per cent ensures that it retains significant influence over Company S.

When an entity loses control of a subsidiary that includes a foreign operation, this is accounted for as a full disposal under IAS 21 irrespective of (1) the nature of the event, transaction or change in circumstances leading to the loss of control, and (2) whether the entity retains an interest in the former subsidiary. Consequently, the cumulative amount of the exchange differences relating to that operation, previously recognised in other comprehensive income and accumulated in equity, is reclassified from equity to profit or loss when the gain or loss on disposal is recognised.

In line with the requirements discussed in 6.3.1, in the circumstances described, notwithstanding Company P’s continuing influence over Company S, all of the exchange differences of CU2.5 million are reclassified from equity to profit or loss and are included in the calculation of the profit or loss on disposal of Company S.

### 6.3 Treatment required for exchange differences when a disposal occurs

#### 6.3.1 Exchange differences attributable to the parent

On disposal of a foreign operation, the cumulative amount of the exchange differences relating to that operation, previously recognised in other comprehensive income and accumulated in a separate component of equity, is reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised. [IAS 21:48]

When a transaction or event is accounted for as a full disposal, all of the relevant exchange differences previously accumulated in equity by the parent are reclassified to profit or loss, even when the entity retains a continuing interest in the investee (see example 6.2).
6.3.2 *Exchange differences attributable to non-controlling interests*

When an entity disposes of a partially-owned subsidiary, the cumulative amount of the exchange differences relating to that foreign operation that have previously been attributed to the non-controlling interests is derecognised, but is not reclassified to profit or loss. [IAS 21:48B]

The cumulative amount of the exchange differences attributable to the non-controlling interests will have been allocated to, and recognised as part of, non-controlling interests in the consolidated statement of financial position, in accordance with IAS 21:41 (see 5.3) and IAS 21:48C (see 6.4.2). The gain or loss recognised in profit or loss on the disposal of a partially-owned subsidiary includes the amount of non-controlling interests derecognised – thus it will already reflect those cumulative exchange differences.

**Example 6.3.2**

*Loss of control of a partially-owned foreign operation – exchange differences attributable to non-controlling interests*

A parent, Company P, has held an 80 per cent interest in a subsidiary, Company S, for a number of years. Company S is a foreign operation and, in accordance with IAS 21:39, exchange differences of CU2.5 million relating to Company S have been recognised in other comprehensive income. 80 per cent of the exchange differences (i.e. CU2 million) have been accumulated in Company P's foreign currency translation reserve in equity, and the remainder has been attributed to non-controlling interests.

Company P disposes of a 31 per cent interest in Company S, resulting in loss of control. Its retained interest of 49 per cent ensures that it retains significant influence over Company S. As illustrated in example 6.2, notwithstanding this continuing influence, all of the exchange differences of CU2.5 million are required to be derecognised.

In accordance with IAS 21:48, the exchange differences attributable to Company P (CU2 million) are reclassified to profit or loss from the foreign currency translation reserve in equity and included in the calculation of the profit or loss on disposal of Company S.

In accordance with IAS 21:48B, the exchange differences attributable to the non-controlling interests (CU0.5 million) are derecognised, but they are not separately reclassified to profit or loss. Those exchange differences were already reflected as part of non-controlling interests in the consolidated statement of financial position and are (as described in paragraph B98 of IFRS 10 *Consolidated Financial Statements* – see 12.3.1 in chapter A24) included in the calculation of the profit or loss on disposal of Company S as part of the carrying amount of the non-controlling interests derecognised.

6.4 *Treatment required for exchange differences when a partial disposal occurs*

6.4.1 *Partial disposal — definition*

A partial disposal of an entity’s interest in a foreign operation is “any reduction in an entity’s ownership interest in a foreign operation, except those reductions in paragraph 48A [see 6.2] that are accounted for as disposals”. [IAS 21:48D] For partial disposals as defined, the Standard distinguishes between:

[IAS 21:48C]

- the partial disposal of a subsidiary that includes a foreign operation (i.e. reduction in ownership interest but control is retained); and
- all other partial disposals.
6.4.2 Partial disposal of a subsidiary that includes a foreign operation

When there is a partial disposal of a subsidiary that includes a foreign operation, entities are required to re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation. [IAS 21:48C]

The transfer, or re-attribution, required in respect of the partial disposal of a subsidiary should be recognised in equity. Therefore, the exchange differences relating to the portion of the investment disposed of are not recognised in profit or loss as a reclassification adjustment at the date of the transaction. Nor are they reclassified to profit or loss at the date of ultimate disposal of the partially-owned subsidiary (see 6.3.2). This treatment, illustrated in example 6.4.2, reflects the general approach adopted under IFRS 10 Consolidated Financial Statements that changes in a parent’s ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Example 6.4.2
Reduction in proportionate interest in a subsidiary that includes a foreign operation

A parent, Company P, has held a 100 per cent interest in a subsidiary, Company S, for a number of years. Company S is a foreign operation and, in accordance with IAS 21:39, exchange differences of CU2.5 million relating to Company S have been recognised in other comprehensive income and accumulated in a separate component of equity.

Entity P disposes of 20 per cent of its interest in Company S, but retains control over the subsidiary. This transaction is classified as a partial disposal of Company S because there has been a reduction in Entity P’s ownership interest but no loss of control.

When a parent disposes of part of its interest in a subsidiary that includes a foreign operation, but it retains control of that subsidiary, IAS 21:48C requires that the parent should re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation.

Consequently, in the circumstances described, at the date of the transaction, 20 per cent of the cumulative exchange differences (i.e. CU0.5 million) are transferred within equity from the foreign currency translation reserve to non-controlling interests. No amounts are reclassified to profit or loss.

6.4.3 Partial disposals other than the partial disposal of a subsidiary

For any partial disposal of a foreign operation other than the partial disposal of a subsidiary, entities are required to reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income. [IAS 21:48C]

Example 6.4.3 illustrates the application of IAS 21:48C to the partial disposal of an associate.
Example 6.4.3
Reduction in proportionate interest in an associate with no loss of significant influence

An investor, Company I, has held a 40 per cent interest in an associate, Company B, for a number of years. Company B is a foreign operation and, in accordance with IAS 21:39, exchange differences of CU50,000 relating to Company B have been recognised in other comprehensive income and accumulated in the foreign currency translation reserve.

Company I disposes of a 10 per cent interest in Company B, but retains significant influence over the associate through its remaining 30 per cent shareholding. This transaction is classified as a partial disposal of Company B because there has been a reduction in Entity P’s ownership interest but no loss of significant influence.

When an investor disposes of part of its interest in an associate that includes a foreign operation but retains significant influence over that associate, IAS 21:48C requires that the investor reclassify to profit or loss the proportionate share of the cumulative amount of the exchange differences previously recognised in other comprehensive income.

Consequently, in the circumstances described, at the date of the transaction one quarter of the cumulative exchange differences (i.e. CU12,500) are reclassified from equity to profit or loss.

6.4.4 Meaning of the term partial disposal — reductions in an entity’s absolute interest with no change in proportionate interest

IAS 21:48D defines a partial disposal of an entity’s interest in a foreign operation as “any reduction in an entity’s ownership interest in a foreign operation, except those reductions in paragraph 48A [of IAS 21] that are accounted for as disposals”. IAS 21 does not provide any further guidance on what is meant by “any reduction in an entity’s ownership interest in a foreign operation”.

When there has been a reduction in the percentage equity ownership of a foreign operation (such as described in example 6.4.2 and example 6.4.3), it is clear that the entity’s ownership interest has been reduced and that, therefore, a partial disposal has occurred. However, there are other transactions that do not affect an investor’s percentage equity ownership but that could be argued to reduce its ownership interest in the foreign operation; for example:

- a pro rata repayment of capital by the foreign operation to all investors;
- repayment of a loan or redemption of non-equity shares that form part of the net investment in the foreign operation; or
- the payment by the foreign operation of a dividend to all shareholders in proportion to their shareholdings.

The question arises as to whether a partial disposal occurs only when there is a reduction in the proportionate (relative) equity ownership interest in a foreign operation or whether a partial disposal can also occur when there is a reduction in the entity’s absolute interest in the foreign operation but no reduction in the proportionate equity ownership interest.
This question was considered by the IFRS Interpretations Committee in September 2010. The Committee considered a proposal to amend the wording of IAS 21:48D to ‘clarify’ that reclassification of exchange differences is appropriate when any absolute reduction in the net investment occurred. This proposal was rejected by the Committee and no consensus emerged. The September 2010 IFRIC Update reported the Committee's decision as follows.

“The Committee considers that different interpretations could lead to diversity in practice in the application of IAS 21 on the reclassification of the FCTR [foreign currency translation reserve] when repayment of investment in a foreign operation occurs. However, the Committee decided neither to add this issue to its agenda nor to recommend the Board to address this issue through Annual Improvements because it did not think that it would be able to reach a consensus on the issue on a timely basis.”

The view expressed by the IFRS Interpretations Committee indicates that the Committee regards both interpretations of the requirements of IAS 21:48D as acceptable.

The ‘proportionate’ approach is straightforward and easily understood and might, therefore, be seen as preferable. Under this method, a transaction that does not reduce the investor's percentage equity ownership of a foreign operation will not result in the reclassification or re-attribution of cumulative exchange differences previously recognised in other comprehensive income.

Application of the ‘absolute’ approach, on the other hand, involves many challenges – particularly in the context of partial disposals of subsidiaries. Under this method, reclassification or re-attribution of amounts held in the foreign currency translation reserve may arise in circumstances when the investor's percentage equity ownership does not change. However, a number of issues arise in applying such an approach that were not addressed by the IFRS Interpretations Committee and that are not explained by IAS 21. These include the following in respect of the mechanics of such an approach:

• the amount that should be re-attributed from the foreign currency translation reserve to non-controlling interests on a pro rata repayment of capital to all equity holders by a partially-owned subsidiary. It is unclear how in these circumstances exchange differences have been ‘transferred’ from the parent to the non-controlling interests; and
• the calculation of the ‘proportionate share’ of exchange differences to reclassify or re-attribute on repayment of a loan that forms part of the net investment in a foreign operation (i.e. the exchange differences relating to the repaid loan or a proportionate amount of the total exchange differences recognised on the investment).

In addition, there are circumstances in which application of an absolute approach does not appear to result in an outcome that is a relevant or representationally faithful depiction of the ‘partial disposal’ transaction:

• it does not appear appropriate to re-attribute amounts from the foreign currency translation reserve to non-controlling interests when a subsidiary that includes a foreign operation is wholly owned before and after the partial disposal transaction; and
• it could be argued that payment of a dividend reduces the absolute interest in an investee. However, IAS 21:BC35 expresses an intention that dividends recognised in profit or loss in accordance with paragraph 12 of IAS 27 Separate Financial Statements cannot be considered a disposal or partial disposal of a net investment in IAS 21.

Entities need to make accounting policy choices between the proportionate and absolute reduction approaches and, if applicable, how the absolute reduction approach is applied. An entity’s accounting policies should be disclosed when material.
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

6.5 Write-downs

A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment loss recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down. [IAS 21:49]

7 Tax effects of exchange differences

Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. IAS 12 *Income Taxes* applies to these tax effects (see chapter A13). [IAS 21:50] IAS 12:61A requires current and deferred tax to be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss.

**Example 7**

**Deferred taxes on translation adjustments**

Entity N is a Norwegian corporation (functional currency Norwegian krone) with a wholly-owned subsidiary, Entity S, operating in the Swedish tax jurisdiction. The functional currency of Entity S is the Swedish krona. Historically, no earnings have been repatriated to Entity N because the parent considers its investment to be permanent.

*Should deferred income tax assets and liabilities be recognised on the adjustments resulting from translation of Entity S’s financial statements into Norwegian krone?*

It depends.

IAS 21:50 provides that any tax effects associated with gains and losses on foreign currency transactions and exchange differences arising from the translation of the financial statements of an entity (including foreign operations) should be accounted for in accordance with IAS 12.

Under IAS 12:39, deferred income tax liabilities may not be accrued by Entity N if both of the following conditions are satisfied:

- Entity N is able to control the timing of the reversal of the temporary difference; and
- it is probable that the temporary difference will not reverse in the foreseeable future.

Recognition of deferred tax assets, in general, would not be appropriate if Entity N’s intention is to maintain the investment in the long term, such that it is not probable that the deferred tax asset would be recovered.

8 SIC-7 Introduction of the Euro

SIC-7 *Introduction of the Euro* explains that the requirements of IAS 21 regarding the translation of foreign currency transactions and financial statements of foreign operations should be applied to the fixing of exchange rates when countries join the Economic and Monetary Union (EMU) and change over to the Euro, as follows:

[SIC-7:4]

(a) foreign currency monetary assets and liabilities resulting from transactions continue to be translated into the functional currency at the closing rate. Any resulting exchange differences are recognised as income or expense immediately, except that an entity continues to apply its existing accounting policy for exchange gains and losses relating to hedges of the currency risk of a forecast transaction;
(b) cumulative exchange differences relating to the translation of financial statements of foreign operations, recognised in other comprehensive income, are accumulated in equity and are reclassified from equity to profit or loss only on the disposal or partial disposal of the net investment in the foreign operation; and

(c) exchange differences resulting from the translation of liabilities denominated in participating currencies should not be included in the carrying amount of related assets.

Example 8
Introduction of the Euro — comparative amounts

The functional currency of Entity A, based in Slovakia, was previously the Slovak Crown. Entity A presented its 31 December 2008 financial statements in that currency. Slovakia adopts the Euro as its national currency on 1 January 2009. Consequently, Entity A needs to recognise a change in functional currency as at 1 January 2009. It will present its financial statements at 31 December 2009 in its new functional currency of the Euro.

The conversion rate from the Slovak Crown to the Euro (also referred to as the ‘parity’ rate) was fixed in July 2008.

How should Entity A translate the comparative information at 31 December 2008 from Slovak Crowns to Euro when preparing its 31 December 2009 financial statements in Euro?

Neither SIC-7 nor IAS 21 directly addresses how comparative amounts should be converted when a change in functional currency arises not from a change in entity-specific circumstances, but because the original functional currency has ceased to exist and is officially converted into another currency at a fixed rate. Paragraph 11 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors indicates that, in the absence of a specific Standard that applies to the transaction, the requirements in IFRSs dealing with similar and related issues should be considered.

Therefore, Entity A has an accounting policy choice. There are two acceptable alternatives:

- it can choose to treat the changeover to the Euro as similar to any other change in presentation currency for the comparative period – in which case it would translate the comparative amounts using rates applicable at the dates of the transactions consistent with IAS 21:38 to 41 (see also 5.7); or
- in the absence of guidance specific to these circumstances, when the change in functional/presentation currency is not due to entity-specific circumstances, Entity A can choose to maintain the relationship between balances by applying the parity rate established on the changeover to the Euro to all the comparative amounts.

9 Presentation and disclosure

9.1 General requirements

The following should be disclosed:

[IAS 21:52]

(a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with IFRS 9 Financial Instruments (or, for entities that have not yet adopted IFRS 9, IAS 39 Financial Instruments: Recognition and Measurement); and

(b) net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

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IAS 21 is silent regarding where in profit or loss foreign currency exchange gains and losses should be presented. The presentation should follow the nature of the transactions to which the foreign currency gains and losses are linked. As such, recognising foreign currency gains and losses relating to operational activities (e.g. on trade receivables/trade payables etc.) within income from operations, and recognising foreign currency exchange gains and losses related to debt in finance costs, would be appropriate. When relevant to an understanding of the entity's financial performance, presentation as a separate line item will be appropriate.

9.2 Change in functional currency

If there has been a change in the functional currency of either

- the reporting entity, or
- a significant foreign operation,

that fact should be stated, and the reason for the change in functional currency disclosed. [IAS 21:54]

As explained in 3.2.8.1, the functional currency of an operation is a matter of fact, not a choice, and it will only change when there is a change in the primary economic environment of the operation. Consequently, it will be appropriate when describing the reason for the change in functional currency to focus on explaining that change in the primary economic environment.

9.3 Presentation currency different from functional currency

If the presentation currency is not the same as the functional currency (or, for a group, the functional currency of the parent), that fact should be stated. The functional currency should be disclosed, together with the reason for using a different presentation currency. [IAS 21:53]

When an entity presents its financial statements in a currency other than its functional currency (or, for a group, in a currency other than the functional currency of the parent), the financial statements may be described as complying with IFRSs only if they comply with all the requirements of each applicable Standard and each applicable Interpretation of those Standards including the translation method set out in IAS 21:39 and 42 (see 4.3 and 4.4). [IAS 21:55]

9.4 Supplementary information in other currencies

When an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency and the requirements of IAS 21:55 are not met (see 9.3), it is required to:

[IAS 21:57]

(a) clearly identify the information as supplementary information, to distinguish it from the information that complies with IFRSs;

(b) disclose the currency in which the supplementary information is displayed; and

(c) disclose the entity's functional currency and the method of translation used to determine the supplementary information.
Entities sometimes present their financial statements or other financial information in a currency that is not the functional currency without meeting the requirements of IAS 21:55. For example, an entity may convert into another currency only selected items from its financial statements; alternatively, an entity whose functional currency is not that of a hyperinflationary economy may convert the financial statements into another currency by translating all items at the most recent closing rate. Such conversions are not in accordance with International Financial Reporting Standards and the disclosures set out above are required. [IAS 21:56]

10 Future developments

In October 2015, the IFRS Interpretations Committee issued a draft Interpretation, DI/2015/2 Foreign Currency Transactions and Advance Consideration. The proposals were developed to provide guidance on how an entity should determine the date of a transaction and, therefore, the spot exchange rate to be used when reporting foreign currency transactions in situations where payment is made or received in advance.

The comment period for the draft Interpretation ended on 19 January 2016. At the time of writing, the final Interpretation is expected to be issued early in 2017.

Chapter A37, Financial Reporting in Hyperinflationary Economies

1 Introduction

1.1 Overview of IAS 29

[IAS 29] Financial Reporting in Hyperinflationary Economies applies when an entity’s functional currency is that of a hyperinflationary economy. The Standard does not prescribe when hyperinflation arises but requires the financial statements (and corresponding figures for previous periods) of an entity with a functional currency that is hyperinflationary to be restated for the changes in the general pricing power of the functional currency.

The premise underlying [IAS 29] is that, because money rapidly loses its purchasing power in a hyperinflationary economy, to report an entity’s operating results and financial position in the currency of that economy without restatement would be meaningless to a user of the financial statements. Comparative information would have no value, and even the profits of a single financial period would be distorted. For example, the difference between the cost at which inventories are acquired and the price at which they are sold would not only reflect a normal trading profit margin, but also include the impact of a price change that is beyond the control of the entity.

1.2 Amendments to IAS 29 since the last edition of this manual

None. [IAS 29] was most recently amended in May 2008.

2 Scope

[IAS 29] addresses the issues associated with financial reporting when the functional currency of an entity (i.e. the currency of the primary economic environment in which the entity operates) is that of a hyperinflationary economy, and it applies equally to the financial statements of individual entities and consolidated financial statements. [IAS 29:1]
The Standard also applies equally to financial statements based on historical cost accounting and those based on current cost accounting (i.e. those reflecting the effects of changes in the specific prices of assets held). In either case, the financial statements should be stated in terms of the measuring unit current at the end of the reporting period.

All entities that report in the currency of a hyperinflationary economy should, ideally, apply [IAS 29] from the same date in order to achieve consistency in financial reporting between entities. However, this objective will not always be achieved. The Standard places responsibility on individual entities to consider the potential impact of hyperinflation and to apply [IAS 29] from the beginning of the reporting period in which they identify the existence of hyperinflation in the country in whose currency they report. [IAS 29:4]

In practice, very few countries fall within the scope of the Standard. Whether or not a country is considered to be experiencing hyperinflation for the purposes of [IAS 29] will generally be determined by a consensus of the accounting profession, rather than by each entity individually.

3 Definition of hyperinflation

[IAS 29] does not establish an absolute rate at which hyperinflation is deemed to arise. Rather, it describes characteristics that may indicate that an economy is hyperinflationary. It is left to the judgement of preparers of financial statements to determine when restatement of financial statements in accordance with [IAS 29] becomes necessary. [IAS 29:3]

Characteristics of the economic environment of a country which indicate the existence of hyperinflation include:

[IAS 29:3]

- the general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;
- the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;
- sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;
- interest rates, wages and prices are linked to a price index; and
- the cumulative inflation rate over three years approaches, or exceeds, 100 per cent.

4 Restatement of financial statements

4.1 General principles for restatement of financial statements

The financial statements of an entity whose functional currency is the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the end of the reporting period. [IAS 29:8]
[IAS 29] notes that one of the most important factors in restating financial statements will be consistency from period to period in applying the procedures and making the judgements required. In other words, the precision of the amounts calculated is less important than consistency of treatment. Because the aim is to provide meaningful financial statements, whatever approach is adopted must be applied consistently in order to achieve comparability between the results for different accounting periods. [IAS 29:10]

4.2 The status of restated financial statements

The financial statements prepared under the requirements of [IAS 29] should be the definitive financial statements of the entity – they should not be seen as supplementary information. Therefore, the Standard prohibits the presentation of information adjusted for the effects of hyperinflation as a supplement to unrestated financial statements. In addition, separate presentation of a set of financial statements before restatement is discouraged. [IAS 29:7]

In hyperinflationary countries, entities are often required to prepare unrestated financial statements for taxation or other authorities. When a set of unrestated financial statements is appended to the [IAS 29] financial statements, or otherwise shown separately (although this is discouraged), the entity will need to make clear that the status of the unrestated financial information is subordinate to the financial statements prepared in accordance with [IAS 29].

4.3 Required adjustments

[IAS 29] requires the following adjustments to amounts reported in the currency of a hyperinflationary economy:


- the current period's financial statements should be stated in terms of the measuring unit current at the end of the reporting period;
- the corresponding figures for the previous period, and any information in respect of earlier periods, should also be stated in terms of the measuring unit current at the end of the reporting period; and
- the gain or loss on the net monetary position (see 4.5) should be included in profit or loss, and separately disclosed.

Restatements are made by applying a general price index. Monetary items, which are already stated at the measuring unit current at the end of the reporting period, are not restated. Other items are restated based on the change in the general price index between the date those items were acquired, incurred or revalued and the end of the reporting period.

4.4 General price index

In order to express financial statements in terms of the measuring unit current at the end of the reporting period, amounts are restated by applying a general price index. The general price index to be used is one that reflects changes in general purchasing power. [IAS 29:37] No further guidance is provided in [IAS 29] on this topic.

The Standard states that it is desirable for all entities reporting in the currency of any particular hyperinflationary economy to use the same index, in order to achieve comparability between the financial statements of different entities. [IAS 29:37]
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

Any reporting entity implementing the principles of [IAS 29] should therefore first consider which price index is used by other local reporting entities, particularly those in the same industry, and apply that index, provided that it is believed to be an indicator of changes in general purchasing power.

A general price index may not be available, particularly for the restatement of the historical cost of property, plant and equipment acquired over an extended period. In such circumstances, the inflation rate may be estimated by considering the depreciation of the exchange rate of the hyperinflationary currency against a relatively stable foreign currency. [IAS 29:17]

In the absence of a reliable, independently determined index (either by the government or the private sector), the movement in the exchange rate between a stable currency (e.g. the US dollar) and the local currency from the beginning to the end of the reporting period may be used as a guideline to determine the index. In making this estimate, it is important that the impact of inflation in the stable currency is excluded.

Example 4.4
Imputing a general price index

Assume that the exchange rate at 1 January 20X5 between Local Currency and Stable Currency is 200:1. At 31 December 20X5, the exchange rate is 350:1. There has been a 75 per cent depreciation in Local Currency in relation to Stable Currency. Assuming that inflation in the Stable Currency economy for the 20X5 calendar year is 3 per cent, the index should be an increase of 80.25 per cent (1.75 × 1.03).

4.5 Gain or loss on net monetary position

An entity’s net monetary position is the difference between its monetary assets and monetary liabilities. Monetary items are defined as money held and items to be received or paid in money. All other items are non-monetary.

The following table lists a number of the most common monetary and non-monetary items.

<table>
<thead>
<tr>
<th>Monetary items</th>
<th>Non-monetary items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>Bank balances and loans</td>
<td>Intangible assets</td>
</tr>
<tr>
<td>Deposits*</td>
<td>Goodwill</td>
</tr>
<tr>
<td>Employee benefit liability**</td>
<td>Shareholders’ equity</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>Prepaid expenses*</td>
</tr>
<tr>
<td>Trade payables</td>
<td>Investments in associates</td>
</tr>
<tr>
<td>Taxation</td>
<td>Advances received on sales or paid on purchases provided that they are linked to specific sales or purchases</td>
</tr>
<tr>
<td>Debt securities</td>
<td>Inventories</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>Allowance for inventory obsolescence (because inventories are non-monetary)</td>
</tr>
</tbody>
</table>
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

(Table continued)

<table>
<thead>
<tr>
<th>Monetary items</th>
<th>Non-monetary items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for doubtful debts (because trade</td>
<td>Deferred income</td>
</tr>
<tr>
<td>receivables are monetary)</td>
<td></td>
</tr>
<tr>
<td>Notes and other receivables</td>
<td>Equity securities</td>
</tr>
<tr>
<td>Notes and other payables</td>
<td>Provisions to be settled by the delivery of a non-monetary asset</td>
</tr>
<tr>
<td>Accrued income</td>
<td></td>
</tr>
<tr>
<td>Holiday pay provision</td>
<td></td>
</tr>
<tr>
<td>Deferred tax assets/liabilities***</td>
<td></td>
</tr>
<tr>
<td>Liabilities recognised for lease contracts</td>
<td></td>
</tr>
</tbody>
</table>

In a period of inflation, an entity holding an excess of monetary assets over monetary liabilities loses purchasing power, and an entity with an excess of monetary liabilities over monetary assets gains purchasing power to the extent that the assets and liabilities are not linked to a price level. [IAS 29:27] The detailed calculation of the gain or loss on net monetary position is dealt with at 5.3.

* When an entity has prepaid expenses, it is necessary to consider whether the prepayment is refundable. When it is refundable, it is similar in nature to a deposit and, therefore, is a monetary item (i.e. it is a right to receive a fixed or determinable number of units of currency). Conversely, when it is not refundable, it is non-monetary (see [IAS 21:16] The Effects of Changes in Foreign Exchange Rates).

** It may be appropriate to regard a defined benefit asset or obligation as a monetary item. But it is possible to argue that some components, particularly relating to equity securities, should be regarded as non-monetary. However, for most entities, this would lead to a level of complexity that is unwarranted.

*** The restatement of deferred tax assets and liabilities is discussed at 4.6.

4.6 Deferred taxes

The restatement of financial statements in accordance with [IAS 29] may give rise to differences between the carrying amount of individual assets and liabilities and their tax bases. These differences are accounted for in accordance with [IAS 12] Income Taxes. [IAS 29:32]

For financial statements restated under [IAS 29], deferred tax is not calculated by simply indexing the historical cost deferred tax amount. Instead, a revised closing deferred tax calculation should be performed using the carrying amounts and tax bases that exist after the restatement for hyperinflationary purposes. Generally, there is no tax relief for hyperinflation and, as such, the tax base will remain unchanged. The difference between the opening restated deferred tax balance, and the revised closing deferred tax balance, is the deferred tax expense or credit for the period.
Example 4.6
Restatement of deferred taxation

At 31 December 20X1, an entity recognised a deferred tax liability related to a non-current asset with a carrying amount of 1,600 and a tax base of 750. The resulting temporary difference of 850 gave rise to a deferred tax liability of 255 (tax rate 30 per cent).

At 31 December 20X2, assuming an index rate of 1.5 and no other movements in the carrying amount or the tax base of the asset, the deferred tax liability is calculated as follows.

<table>
<thead>
<tr>
<th>Carrying amount (1,600 × 1.5)</th>
<th>2,400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax base</td>
<td>(750)</td>
</tr>
<tr>
<td>Temporary difference</td>
<td>1,650</td>
</tr>
<tr>
<td>Deferred tax at 30%</td>
<td>495</td>
</tr>
</tbody>
</table>

The opening deferred tax balance of 255 should be indexed by 1.5. The effect of this is that the comparative information in respect of deferred tax is restated to 382.50. In performing a revised deferred tax computation at the end of the current year, the closing deferred tax balance should be 495. Accordingly, the difference between the closing deferred tax amount of 495 and the restated opening deferred tax amount of 382.50 (i.e. 112.50) is the current year deferred tax expense.

4.7 Statement of cash flows

[IAS 29] requires that all items in the statement of cash flows are expressed in terms of the measuring unit current at the end of the reporting period. [IAS 29:33]

4.8 Consolidated financial statements

A parent that reports in the currency of a hyperinflationary economy may have subsidiaries that also report in the currencies of hyperinflationary economies. The financial statements of any such subsidiary need to be restated by applying the general price index of the country in whose currency it reports before they are included in the consolidated financial statements issued by the parent. When such a subsidiary is a foreign subsidiary, its restated financial statements are translated at closing rates. The financial statements of subsidiaries that do not report in the currencies of hyperinflationary economies are dealt with in accordance with [IAS 21] (see chapter A19). [IAS 29:35]

If financial statements with different reporting dates are consolidated, all items, whether non-monetary or monetary, need to be restated into the measuring unit current at the date of the consolidated financial statements. [IAS 29:36]

4.9 IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies

In the first year in which an entity identifies the existence of hyperinflation, it must start applying [IAS 29] as if the economy had always been hyperinflationary. Therefore, an entity recreates an opening statement of financial position at the beginning of the earliest annual accounting period presented in the restated financial statements so that:

[IFRIC 7:3]

- non-monetary items measured at historical cost are restated to reflect the effect of inflation from the date the assets were acquired and the liabilities incurred or assumed until the end of the reporting period; and
- non-monetary items carried at amounts current at dates other than those of acquisition or incurrence are restated to reflect the effect of inflation from the dates those carrying amounts were determined until the end of the reporting period.

Deferred tax amounts in the opening statement of financial position for the reporting period are determined as follows:

[IFRIC 7:4]

- deferred tax items are remeasured in accordance with [IAS 12] after the entity has restated the nominal carrying amounts of its non-monetary items at the beginning of the reporting period by applying the measuring unit at that date; and
- those deferred tax items are restated for the change in the measuring unit from the beginning of the reporting period to the end of that reporting period.

The approach above is applied in the opening statement of financial position of any comparative periods presented in the restated financial statements for the reporting period in which the entity applies [IAS 29].

All corresponding amounts (including deferred tax items) in subsequent financial statements are restated by applying the change in the measuring unit for the subsequent reporting period only to the restated financial statements for the previous reporting period. [IFRIC 7:5]

The Interpretation is accompanied by an illustrative example which shows the mechanics of the restatement approach for deferred tax items.
5 Historical cost financial statements

5.1 Statement of financial position

5.1.1 Approach for components of historical cost statement of financial position — summary

The approaches required by [IAS 29] for the components of a historical cost statement of financial position are summarised in the table below. Specific categories are considered in 5.1.2 to 5.1.7.

<table>
<thead>
<tr>
<th>Item in the statement of financial position</th>
<th>Treatment</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets and liabilities having a predefined link to price changes</td>
<td>Adjust in accordance with the particular agreements in place</td>
<td>Index-linked bonds and loans</td>
</tr>
<tr>
<td>Other monetary items</td>
<td>These do not require restatement because they are already expressed in terms of the measuring unit current at the end of the reporting period</td>
<td>Cash, receivables and payables</td>
</tr>
<tr>
<td>Non-monetary assets carried at a valuation that is current at the end of the reporting period</td>
<td>These do not require restatement because they are already expressed in terms of the measuring unit current at the end of the reporting period</td>
<td>Inventories carried at net realisable value. Investment property carried at fair value</td>
</tr>
<tr>
<td>Non-monetary assets carried at a valuation that is not current at the end of the reporting period</td>
<td>Restatement is required from the date of the valuation to the end of the reporting period</td>
<td>Property revalued at a date other than the end of the reporting period</td>
</tr>
<tr>
<td>Other items in the statement of financial position, i.e. items carried at cost, or cost less depreciation and impairment losses</td>
<td>These are restated in terms of the measuring unit current at the end of the reporting period by applying a general price index</td>
<td>When carried at cost: property, plant and equipment, investments (if carried at cost, in accordance with [IAS 39]), inventories, goodwill and intangible assets. Also prepaid expenses and deferred income.</td>
</tr>
</tbody>
</table>

5.1.2 Property, plant and equipment

5.1.2.1 Property, plant and equipment carried at valuation

Property, plant and equipment carried at a valuation that is current at the end of the reporting period need not be restated because the assets are already expressed in terms of the measuring unit current at the end of the reporting period. [IAS 29:14]

For property, plant and equipment carried at a valuation that is not current at the end of the reporting period, the change in the general price index from the date of the last valuation of the item to the end of the reporting period is applied to the revalued amount. [IAS 29:18]

5.1.2.2 Property, plant and equipment carried at cost less accumulated depreciation and accumulated impairment losses

For property, plant and equipment stated at cost less depreciation and impairment losses, the change in the general price index from the date of acquisition of the item to the end of the reporting period is applied to the historical cost and, when relevant, accumulated depreciation and accumulated impairment losses. [IAS 29:15]
The treatment of items of property, plant and equipment that have been depreciated can often be complex. Cost is restated by adjusting the purchase price by the change in the index between the date of acquisition and the end of the reporting period. Depreciation arises over time and, therefore, the balance of accumulated depreciation brought forward at the beginning of each period should be adjusted by the change in the index between the beginning and the end of the period, while the depreciation expense for each period is calculated based on the index-adjusted cost at the end of the period. Another way to arrive at the same answer is to apply the depreciation rate to the historical cost and apply the index from the date of acquisition of the asset to the end of the reporting period.

Example 5.1.2.2
Restatement of property, plant and equipment

An entity acquires an item of property, plant and equipment on 31 December 20X1 for 1,000, when the general price index is 100. At 31 December 20X2, the index is 140 and the asset has been depreciated by 10 per cent. At 31 December 20X3, the index is 190 and the asset has been depreciated at 10 per cent for a second year.

<table>
<thead>
<tr>
<th></th>
<th>Balance brought forward</th>
<th>Indexing adjustment</th>
<th>Calculation of accumulated depreciation</th>
<th>Adjusted balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost at 31 December 20X1</td>
<td>1,000</td>
<td>140/100</td>
<td></td>
<td>1,400</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td></td>
<td>(1,400 × 10%)</td>
<td>(140)</td>
</tr>
<tr>
<td>At 31 December 20X2</td>
<td></td>
<td></td>
<td></td>
<td>1,260</td>
</tr>
<tr>
<td>Cost</td>
<td>1,400</td>
<td>190/140</td>
<td></td>
<td>1,900</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(140)</td>
<td></td>
<td>(140 × 190/140) + (1,900 × 10%)*</td>
<td>(380)</td>
</tr>
<tr>
<td>At 31 December 20X3</td>
<td></td>
<td></td>
<td></td>
<td>1,520</td>
</tr>
</tbody>
</table>

Footnote:
* The depreciation expense for the period 1 January 20X3 to 31 December 20X3 can also be expressed as 1,000 × 10% × 190/100.

In the first period of application of [IAS 29], it may be difficult to establish the basis for restatement of information due to the absence of detailed records of the acquisition dates of items of property, plant and equipment. In the rare circumstances when it is not practicable to make a reliable estimate, the Standard suggests that it may be appropriate to use an independent professional assessment of the value of the items as the basis for their restatement. [IAS 29:16]

5.1.3 Inventories

In the restatement of a historical cost statement of financial position:

[IAS 29:15]

- inventories of raw materials and merchandise are to be restated by applying the change in the general price index from the date of acquisition to the end of the reporting period; and
- work in progress and finished goods are restated from the dates on which the costs of purchase and of conversion were incurred. This may prove to be a complex exercise, particularly when products take a long period to manufacture, as illustrated in example 5.1.3.
Raw materials should be restated from acquisition to the end of the reporting period, taking into account whether FIFO or weighted average is applied.

For work in progress and finished goods:

- any historical cost depreciation included in the carrying amount should be restated; and
- raw material content and labour and overhead included in the carrying amount will have different ageing. For example, suppose that, on average, finished goods are one month old and, on average, there are four months of raw material inventories in finished goods. In that case, the labour and overhead content in finished goods should be indexed for one month only and the raw material content in finished goods should be indexed by five months.

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**Example 5.1.3**
**Restatement of inventories**

An entity operating in a hyperinflationary economy is preparing financial statements at its period end, 31 December. Assume labour and overheads are utilised evenly over a period, and the following changes in the general price index apply:

<table>
<thead>
<tr>
<th>Date</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 August</td>
<td>100</td>
</tr>
<tr>
<td>30 September</td>
<td>105</td>
</tr>
<tr>
<td>31 October</td>
<td>110</td>
</tr>
<tr>
<td>30 November</td>
<td>115</td>
</tr>
<tr>
<td>31 December</td>
<td>120</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Historical cost at end of the reporting period</th>
<th>Indexing adjustment</th>
<th>31 December adjusted balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Raw materials</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchased 31 October</td>
<td>250</td>
<td>120/110</td>
<td>273</td>
</tr>
<tr>
<td>Purchased 30 November</td>
<td>250</td>
<td>120/115</td>
<td>261</td>
</tr>
<tr>
<td><strong>Work in progress</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Use of raw materials purchased 30 September</td>
<td>500</td>
<td>120/105</td>
<td>571</td>
</tr>
<tr>
<td>Labour / overheads incurred from 31 October to 31 December</td>
<td>500</td>
<td>120/115*</td>
<td>522</td>
</tr>
<tr>
<td><strong>Finished goods</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Use of raw materials purchased 31 August</td>
<td>500</td>
<td>120/100</td>
<td>600</td>
</tr>
<tr>
<td>Labour / overheads incurred from 30 September to 31 December</td>
<td>500</td>
<td>120/112.5**</td>
<td>533</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,500</td>
<td>120/112.5**</td>
<td>2,760</td>
</tr>
</tbody>
</table>

**Footnotes**

* 115 is the average for October to December

** 112.5 is the average for September to December
5.1.4 Investments accounted for using the equity method

When the entity holds an investment that is accounted for using the equity method, and the investee reports in the currency of a hyperinflationary economy, the following steps are followed:

[IAS 29:20]

- the statement of financial position and statement of comprehensive income of the investee are restated in accordance with [IAS 29] in order to calculate the investor's share of its net assets and profit or loss; and
- when the restated financial statements of the investee are expressed in a foreign currency, they are translated at closing rates.

5.1.5 Borrowing costs

In a hyperinflationary economy, the impact of inflation is usually recognised in borrowing costs. A loan agreement may provide for repayment of capital adjusted by a predefined index, with interest being charged at a ‘normal’ rate. Alternatively, loans may be negotiated at an interest rate in excess of the ‘normal’ rate that compensates for the loss in purchasing power of the money being loaned. When an entity operates in a hyperinflationary economy, only the ‘normal’ element of the borrowing costs may be capitalised (see chapter A18). It is inappropriate to capitalise that part of the borrowing costs that compensates for inflation. This portion should be expensed as incurred. [IAS 29:21]

When assets are acquired on deferred payment terms with no explicit charge for interest, and it is impracticable to impute an amount of interest, the Standard allows that such assets are restated from the payment date and not the date of purchase. [IAS 29:22]

The logic for the treatment outlined in the previous paragraph is as follows. Normally, if resources flow out of the entity at the later date without any additional cost, the net monetary position can only be affected from that date. However, in practice, in a hyperinflationary economy, credit is only likely to be given if the cost of the asset is increased to compensate the seller for the loss in purchasing power of the cash during the credit period. Therefore, it should be possible to impute an interest rate to the transaction and therefore capitalise the asset at a lower amount. The interest itself will be recognised in profit or loss and the asset will be restated from the date of purchase. If no amount of interest can be imputed, then a reasonable approximation to this technically ‘correct’ position may be achieved by including the asset in the accounts at the value actually paid and applying the index from the payment date.

5.1.6 Impairment

When a non-monetary item has been restated, the restated amount is compared with the item's recoverable amount. When the restated amount exceeds the recoverable amount, an impairment loss is recognised with the effect that:

[IAS 29:19]

- inventories will be written down to net realisable value in accordance with [IAS 2] Inventories (see chapter A11); and
- items of property, plant and equipment, and intangible assets, will be reduced to their recoverable amount in accordance with [IAS 36] Impairment of Assets (see chapter A10).
5.1.7 **Equity**

When [IAS 29] is first applied, the components of owners’ equity at the beginning of the period will be adjusted as follows:

[IAS 29:24]

- any revaluation surplus that arose in previous periods is eliminated (i.e. it is absorbed in adjusted retained earnings);
- with the exception of retained earnings, other components (equity, share premium and any other existing reserves) are restated by applying a general price index from the dates the components were contributed or otherwise arose; and
- restated retained earnings are calculated as the balancing figure after all adjustments have been made to all other components of the statement of financial position.

At the end of the first period, and in subsequent periods, all components of equity are again restated, this time by applying a general price index from the beginning of the period or the date of contribution, whichever is the later. These movements should be disclosed in the statement of changes in equity in accordance with [IAS 1] Presentation of Financial Statements. [IAS 29:25]

Note that the elimination of a revaluation surplus is required only when [IAS 29] is first applied. [IAS 29] does not include a requirement that subsequent revaluations of property, plant and equipment or intangible assets, to the extent that they exceed the remeasurement arising from inflation, should be recognised in retained earnings. Such revaluations should be recognised in a revaluation surplus.

**Example 5.1.7**

**Restatement of components of equity relating to revalued property, plant and equipment**

An entity acquires an item of property, plant and equipment on 31 December 20X1 for 1,000 when the general price index is 100. At 31 December 20X2, the index is 140. The entity’s policy is to revalue its property, plant and equipment. At 31 December 20X2, the item of property, plant and equipment has a fair value of 1,500.

<table>
<thead>
<tr>
<th></th>
<th>Historical cost</th>
<th>Indexing adjustment</th>
<th>Adjusted balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>1,000</td>
<td>140/100</td>
<td>1,400</td>
</tr>
<tr>
<td>Revaluation surplus</td>
<td></td>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

5.2 **Statement of comprehensive income**

5.2.1 **Approach for components of historical cost statement of comprehensive income — general**

As for the statement of financial position, all items in the statement of comprehensive income should be expressed in terms of the measuring unit current at the end of the reporting period. Again, this is achieved by applying the change in a general price index from the dates when the income and expenses were first recorded. [IAS 29:26]
Because there may be a large number of transactions in the statement of comprehensive income, some estimation may be necessary. Furthermore, the general price index selected may not be published daily. Clearly, if prices are rising at a reasonably steady rate, and if the transactions being adjusted arise evenly, it may be sufficient to approximate using an average movement in the general price index over a period. However, judgement is required as to whether an average will result in a fair approximation. For example, if there are large, irregular transactions, an average rate will be unsuitable and actual rates should be used.

5.2.2 Depreciation
The method of calculating the charge for depreciation is illustrated in example 5.1.2.2.

5.2.3 Cost of goods sold
Another potentially complex area is the calculation of the cost of goods sold for inclusion in the statement of comprehensive income.

All amounts included in cost of goods sold should be restated by applying the change in the general price index from the dates when the items of income and expense were initially recognised in the financial statements. The following steps may be required:

- obtain a monthly breakdown of the items included in production costs;
- restate all components of production costs, except depreciation and raw materials, from the month when the costs were incurred to the end of the reporting period;
- calculate raw material used in the production process through the reconciliation of restated opening raw materials and closing raw materials balances;
- calculate depreciation related to production costs on the basis of the restated property, plant and equipment, and replace the historical depreciation with this restated depreciation; and
- restate opening and closing historical finished goods and work in progress.

The amount of the restated cost of goods sold is obtained by adding the restated opening finished goods and work in progress to purchases and other production costs restated from the date when the cost was incurred, and deducting the restated closing finished goods and work in progress. The restated opening finished goods and work in progress are derived by (1) restating amounts to the purchasing power at the end of the prior reporting period, and (2) inflating the resultant restated cost of opening amounts by the conversion factor for the entire year.
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

Example 5.2.3  
Restatement of cost of goods sold

An entity has inventories of 200 at the beginning of the period, when the general price index is at 100. Purchases of 1,200 are made at an even rate throughout the year and closing inventories are 200. The closing inventories were acquired in two instalments in the last two months of the year, when the index was 120 and 122, respectively. At the end of the reporting period, the general price index is 124, and inflation rose steadily all year, giving an average rate of 112.

<table>
<thead>
<tr>
<th></th>
<th>Unadjusted balances</th>
<th>Indexing adjustment</th>
<th>Adjusted balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening inventories</td>
<td>200</td>
<td>124/100</td>
<td>248</td>
</tr>
<tr>
<td>Purchases</td>
<td>1,200</td>
<td>124/112</td>
<td>1,329</td>
</tr>
<tr>
<td>Closing inventories</td>
<td>(100)</td>
<td>124/120</td>
<td>(103)</td>
</tr>
<tr>
<td></td>
<td>(100)</td>
<td>124/122</td>
<td>(102)</td>
</tr>
<tr>
<td></td>
<td>(200)</td>
<td></td>
<td>(205)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,200</td>
<td></td>
<td>1,372</td>
</tr>
</tbody>
</table>

5.2.4 Current taxation

The current taxation expense accrues over the period. Therefore, the restated current taxation expense is calculated by restating monthly tax expenses for each month in terms of purchasing power at the end of the reporting period, using the increase in the general price index from the related month until the end of the reporting period. If the index has been rising at a reasonably steady rate, the current tax at the end of the reporting period may be indexed using average rates (i.e. as for other expenses). The difference between the opening restated deferred tax balance, and the revised closing deferred tax balance (as discussed at 4.6) should be added to the above amount. (In example 4.6, this amount will be 112.50).

5.3 Gain or loss arising on net monetary position

The gain or loss arising on the net monetary position as a result of all of the adjustments to items in the statement of financial position is included in profit or loss and separately disclosed. [IAS 29] suggests that the gain or loss may be estimated by applying the change in the general price index to the weighted average for the period of the difference between monetary assets and monetary liabilities. However, it is more accurately calculated as the difference arising from:

[IAS 29:27]
- the restatement of non-monetary assets, owners’ equity and items in the statement of comprehensive income; and
- the adjustment of index-linked assets and liabilities (when these exist), such as index-linked bonds and loans.
Appendix C — The Effects of Changes in Foreign Exchange Rates and Financial Reporting in Hyperinflationary Economies Under IFRSs

The Standard indicates that separate, but linked, disclosure may be appropriate in the statement of comprehensive income of:

[IAS 29:28]

- the net effect of restating non-monetary assets, owners’ equity and items in the statement of comprehensive income;
- the net effect of adjusting any index-linked assets and/or liabilities;
- interest income and expense; and
- foreign exchange differences relating to invested and/or borrowed funds.

Example 5.3
Gain or loss arising on net monetary position

An entity has a loan linked to an index which was 100 at the start of the period and at the period end is 125. In preparing its financial statements, the entity uses a different index, which at the start of the period was 100 and at the period end is 120. Inflation is assumed to have occurred at an even rate throughout the period. The unadjusted depreciation expense for the period relates to assets acquired (on average) when the index stood at 80. (Note that, for simplicity, this example ignores the effects of taxation.)

<table>
<thead>
<tr>
<th></th>
<th>Unadjusted balances</th>
<th>Indexing adjustment</th>
<th>Adjusted balances</th>
<th>Gain/ (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-monetary assets</td>
<td>1,000</td>
<td>120/100</td>
<td>1,200</td>
<td>200</td>
</tr>
<tr>
<td>Monetary assets</td>
<td>500</td>
<td>500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Index-linked loan</td>
<td>(100)</td>
<td>125/100</td>
<td>(125)</td>
<td>(25)</td>
</tr>
<tr>
<td>Monetary liabilities</td>
<td>(100)</td>
<td></td>
<td>(100)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,300</td>
<td></td>
<td>1,475</td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td>500</td>
<td>120/100</td>
<td>600</td>
<td>(100)</td>
</tr>
<tr>
<td>Retained earnings b/f</td>
<td>600</td>
<td>120/100</td>
<td>720</td>
<td>(120)</td>
</tr>
<tr>
<td>Profit for the period:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– before depreciation</td>
<td>250</td>
<td>120/110*</td>
<td>273</td>
<td>(23)</td>
</tr>
<tr>
<td>– less depreciation</td>
<td>(50)</td>
<td>120/80**</td>
<td>(75)</td>
<td>25</td>
</tr>
<tr>
<td>Profit after depreciation</td>
<td>200</td>
<td>198</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net monetary and index loss</td>
<td>—</td>
<td></td>
<td>(43)**</td>
<td>(43)</td>
</tr>
<tr>
<td>Retained earnings c/f</td>
<td>800</td>
<td></td>
<td>875</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,300</td>
<td></td>
<td>1,475</td>
<td></td>
</tr>
</tbody>
</table>

Note that the loss of 25 on the index-linked loan has been shown separately in the column on the right as separate disclosure is suggested by [IAS 29].

Footnotes:
* average rate
** calculated as demonstrated in example 5.1.2.2
*** calculated as demonstrated in the column on the right
6 Current cost financial statements

6.1 Statement of financial position

As is clear from the discussion in earlier sections in this chapter, items in the statement of financial position already carried at a current valuation do not require restatement, because they are already expressed in terms of the measuring unit current at the end of the reporting period. Therefore, in current cost financial statements, items of property, plant and equipment, investments and inventories, which will have been restated to current cost, do not require further adjustment. Items linked to changes in prices will be adjusted in accordance with the relevant agreements, and other monetary items will again require no adjustment. [IAS 29:29]

Other items in the statement of financial position will, however, need to be restated. This includes goodwill, deferred credits and components of owners’ equity. The guidance outlined in section 5 for items in a historical cost statement of financial position should be applied. [IAS 29:29]

6.2 Statement of comprehensive income

The current cost statement of comprehensive income, before restatement, generally reports costs current at the time at which the underlying transactions or events occurred. Cost of sales and depreciation are recognised at current costs at the time of consumption; sales and other expenses are recorded at their monetary amounts when they occurred. All of these amounts in the statement of comprehensive income should be restated in the measuring unit current at the end of the reporting period by applying a general price index. [IAS 29:30]

6.3 Gain or loss on net monetary position

The gain or loss on the net monetary position is accounted for as set out for historical cost financial statements (see 5.3). [IAS 29:31]

In current cost financial statements, there may already be an adjustment taking items from a historical cost basis to a current cost basis. Such adjustments are treated as part of the gain or loss on the net monetary position, and the two amounts will be treated as one for the purpose of disclosure.

7 Economies ceasing to be hyperinflationary

There are two simple rules to be applied when the economy ceases to be hyperinflationary:

[IAS 29:38]

- the entity should cease to prepare its financial statements in accordance with [IAS 29]; and
- the carrying amounts of assets and liabilities in the entity’s previous set of financial statements, which are the opening balances for the period in which the economy ceases to be hyperinflationary, should be treated as the basis for the carrying amounts in its subsequent financial statements. No adjustment is required to any balances in the financial statements.
8 Disclosure
The following disclosures are required:

[IAS 29:39]

- the fact that the financial statements and the corresponding figures have been restated for changes in the general purchasing power of the functional currency and, consequently, are stated in terms of the measuring unit current at the end of the reporting period;
- whether the financial statements are based on a historical cost approach or a current cost approach; and
- the price index that has been used, its level at the end of the reporting period and the movement in the index during the current and previous reporting periods.

The Standard does not further specify what is meant by the ‘movement in the index’ during the current and prior periods. Simple disclosure of the level of the index at the start of the current and previous periods may not, however, be sufficient. An indication should also be given of the extent of fluctuations during the period when these are material.
Appendix D — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

**AICPA Literature**
TIS Section 2210.27, “Construction of Asset — Foreign Currency Transaction Gains/Losses”

**FASB Accounting Standards Updates (ASUs)**
2016-13, *Measurement of Credit Losses on Financial Instruments*
2016-02, *Leases*
2015-03, *Simplifying the Presentation of Debt Issuance Costs*
2014-09, *Revenue From Contracts With Customers*

**FASB Accounting Standards Codification (ASC) Topics**
ASC 220, *Comprehensive Income*
ASC 225, *Income Statement*
ASC 250, *Accounting Changes and Error Corrections*
ASC 255, *Changing Prices*
ASC 275, *Risks and Uncertainties*
ASC 280, *Segment Reporting*
ASC 320, *Investments — Debt and Equity Securities*
ASC 323, *Investments — Equity Method and Joint Ventures*
ASC 330, *Inventory*
ASC 360, *Property, Plant, and Equipment*
ASC 450, *Contingencies*
ASC 460, *Guarantees*
ASC 470, *Debt*
ASC 480, *Distinguishing Liabilities From Equity*
Appendix D — Glossary of Standards and Other Literature

ASC 505, **Equity**
ASC 605, **Revenue Recognition**
ASC 606, **Revenue From Contracts With Customers**
ASC 715, **Compensation — Retirement Benefits**
ASC 718, **Compensation — Stock Compensation**
ASC 740, **Income Taxes**
ASC 805, **Business Combinations**
ASC 810, **Consolidation**
ASC 815, **Derivatives and Hedging**
ASC 820, **Fair Value Measurement**
ASC 825, **Financial Instruments**
ASC 830, **Foreign Currency Matters**
ASC 835, **Interest**
ASC 840, **Leases**
ASC 842, **Leases**
ASC 845, **Nonmonetary Transactions**

**FASB Statements of Financial Accounting Standards (Pre-Codification Literature)**


No. 95, *Statement of Cash Flows*

No. 52, *Foreign Currency Translation*

**EITF Issues (Pre-Codification Literature)**

D-12, "Foreign Currency Translation — Selection of Exchange Rate When Trading Is Temporarily Suspended"

D-55, "Determining a Highly Inflationary Economy under FASB Statement No. 52"

**SEC Division of Corporation Finance Financial Reporting Manual**

Topic 6, “Foreign Private Issuers and Foreign Businesses”

**SEC Regulation S-K**

Item 10(e), “General: Use of Non-GAAP Financial Measures in Commission Filings”

Item 303, “Management's Discussion and Analysis of Financial Condition and Results of Operations”

Item 305, “Quantitative and Qualitative Disclosures About Market Risk”

Item 503(c), “Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges: Risk Factors”
Appendix D — Glossary of Standards and Other Literature

**SEC Regulation S-X**
Rule 3-20, “Currency for Financial Statements of Foreign Private Issuers"
Rule 3A-02, “Consolidated Financial Statements of the Registrant and Its Subsidiaries”

**SEC Staff Accounting Bulletins**
SAB Topic 13, “Revenue Recognition”
SAB Topic 13.A.4, “Fixed or Determinable Sales Price”

**SEC Compliance and Disclosure Interpretation (C&DI) Topic**
Non-GAAP Financial Measures

**International Standards**
IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*
IFRS 9, *Financial Instruments*
IFRS 10, *Consolidated Financial Statements*
IFRS 11, *Joint Arrangements*
IFRS 16, *Leases*
IAS 10, *Events*
IAS 12, *Income Taxes*
IAS 16, *Property, Plant and Equipment*
IAS 19, *Employee Benefits*
IAS 21, *The Effects of Changes in Foreign Exchange Rates*
IAS 27, *Separate Financial Statements*
IAS 28, *Investments in Associates*
IAS 29, *Financial Reporting in Hyperinflationary Economies*
IAS 32, *Financial Instruments: Presentation*
IAS 36, *Impairment of Assets*
IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*
IAS 39, *Financial Instruments: Recognition and Measurement*
IFRIC 1, *Changes in Existing Decommissioning*
IFRIC 7, *Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies*
IFRIC 16, *Hedges of a Net Investment in a Foreign Operation*
### Appendix E — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFS</td>
<td>available for sale</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>AOCI</td>
<td>accumulated other comprehensive income</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>BRL</td>
<td>Brazilian real</td>
</tr>
<tr>
<td>BsF</td>
<td>Venezuelan Bolivar</td>
</tr>
<tr>
<td>C&amp;DI</td>
<td>SEC Compliance and Disclosure Interpretation</td>
</tr>
<tr>
<td>CAD</td>
<td>Canadian dollars</td>
</tr>
<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
</tr>
<tr>
<td>CPI</td>
<td>consumer price index</td>
</tr>
<tr>
<td>CTA</td>
<td>cumulative translation adjustment</td>
</tr>
<tr>
<td>DTA</td>
<td>deferred tax asset</td>
</tr>
<tr>
<td>DTL</td>
<td>deferred tax liability</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<tr>
<td>FC</td>
<td>foreign currency</td>
</tr>
<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
</tr>
<tr>
<td>GBP</td>
<td>British pound sterling</td>
</tr>
<tr>
<td>GDP</td>
<td>gross domestic product</td>
</tr>
<tr>
<td>HTM</td>
<td>held to maturity</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPTF</td>
<td>International Practices Task Force</td>
</tr>
<tr>
<td>LC</td>
<td>local currency</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>Management's Discussion and Analysis</td>
</tr>
<tr>
<td>MXN</td>
<td>Mexican peso</td>
</tr>
<tr>
<td>NCI</td>
<td>noncontrolling interest</td>
</tr>
<tr>
<td>OCI</td>
<td>other comprehensive income</td>
</tr>
<tr>
<td>OTTI</td>
<td>other-than-temporary impairment</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>property, plant, and equipment</td>
</tr>
<tr>
<td>ROU</td>
<td>right of use</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>Securities Act</td>
<td>Securities Act of 1933</td>
</tr>
<tr>
<td>TIS</td>
<td>AICPA Technical Inquiry Service</td>
</tr>
<tr>
<td>USD</td>
<td>U.S. dollar</td>
</tr>
<tr>
<td>VIE</td>
<td>variable interest entity</td>
</tr>
<tr>
<td>WEO</td>
<td>World Economic Outlook</td>
</tr>
<tr>
<td>WPI</td>
<td>wholesale price index</td>
</tr>
<tr>
<td>ZAR</td>
<td>South African rand</td>
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