Foreign Currency Matters

New Guidance for Derecognition of Cumulative Translation Adjustments

By Josef Rashty

In March 2013, FASB issued Accounting Standards Update (ASU) 2013-05, *Foreign Currency Matters* [Accounting Standards Codification (ASC) Topic 830, "Foreign Currency Matters"], to address the diversity in practice regarding the release of cumulative translation adjustments (CTA) into earnings upon the occurrence of certain events, such as when a reporting entity's (parent company's) percentage of ownership interest in a foreign entity or foreign equity investment changes. The ensuing discussion provides a review of ASC Topic 830 on foreign currency translations that result in recognition of gains and losses in other comprehensive income (OCI). It also addresses the new guidance, ASU 2013-05, for reclassification of these CTAs into earnings or other accounts when the reporting entity's percentage of ownership in the foreign subsidiary or foreign investment changes.

Overview

ASC Topic 830 provides guidance on foreign currency measurements and translations. The first step in the process is to identify the functional currency. Next, the accounts that are not denominated in the functional currency should be remeasured into the functional currency, and the result of the remeasurement should be reflected in earnings. After completion of the remeasurement process, the foreign entity's financial statements should be translated into the reporting entity's functional currency, and the translation adjustment should be reflected as CTA in OCI in the equity section of the reporting entity's balance sheet.

Foreign entity. A foreign entity is an operation (e.g., a subsidiary) that has financial statements possessing the following characteristics:

- They are prepared in a currency other than the reporting currency of the reporting entity (i.e., the reporting entity and foreign entity have different functional currencies).
- They are combined, consolidated with, or accounted for on the equity basis in the reporting entity's financial statements.

A foreign entity does not necessarily need to be a legal entity. Any operation that is separate and distinct and has assets, liabilities, revenues, and expenses that are separate from those of other operations can be a foreign entity if it meets the two above criteria. In addition, a foreign entity has a separate management team and a stand-alone business plan, and it is able to produce financial statements for its operation.

Foreign currency. The definition of foreign currency is relatively straightforward. It is a currency other than the functional currency of the reporting entity. For example, if the functional currency of a reporting entity is U.S. dollars, any other currency (e.g., euros) is considered a foreign currency.

Foreign currency transactions. These are transactions denominated in a currency other than the reporting entity's functional currency. For example, a reporting entity is engaged in a foreign transaction when it buys or sells goods in a foreign currency. All foreign currency transactions must be measured initially in the functional currency of the reporting entity at the exchange rate in effect at that date. At each subsequent balance sheet date, balances related to such transactions must be adjusted to reflect the current exchange rates.

CTAs. The financial statements of foreign entities must be translated into the functional currency of the reporting entity prior to consolidation. The translation adjustments (gains and losses) should be recorded in a separate component of stockholders equity (i.e., OCI). These cumulative gains and losses are referred to as CTAs.

Functional Currency

It is important to properly determine a foreign entity's functional currency because the remeasurement and translation provisions of ASC Topic 830 are based on the functional currency of each foreign entity. According to ASC 830-10-45-2, the functional currency of a foreign entity is the currency of the primary economic environment in which it operates (i.e., generates and expends cash).

ASC 830-10-45-4 discusses the following two classes of foreign entities for the purposes of determining their proper functional currency:

- Foreign entities that are relatively self-contained, whose operations are integrated within their particular economic environment. The daily operations of these foreign entities are independent from the economic environment of the reporting entity. The cash flows of these foreign entities are mainly in foreign currency and do not directly affect the reporting entity's cash flow. The functional currency of such foreign entities is the foreign currency of the environment in which they are operating.
- Foreign entities that are primarily direct extensions of the reporting entities and are integrated with their operations. Their cash flows are primarily based on the reporting entity's cash flow. The functional currency of these foreign entities is the reporting entity's functional currency.

Remeasurement of Foreign Currency Accounts

ASC Topic 830 makes an important distinction between the concepts of remeasurement and translation. If a foreign entity has certain accounts in nonfunctional currency, such accounts must be remeasured prior to translation. The objective of the remeasurement process is to produce the same result as if the entity's records had been maintained in its functional currency. ASC Topic 830 defines remeasurement as the process of measuring in the functional currency the amounts that are denominated in currencies other than the functional currency.

Example. Entity P has a foreign subsidiary, Entity S, in Germany that has a functional currency of euros, whereas the functional currency of Entity P is U.S. dollars. Entity S maintains a U.S.–dollar bank account. ASC Topic 830 requires that the U.S.–dollar bank account be remeasured into euros (Entity S's functional currency) and that any gains or losses due to foreign currency remeasurement be reflected in earnings. The fact that the functional currency of Entity P happens to be U.S. dollars is irrelevant in this case.

ASC 830-10-45-17 and -18 require that foreign entities use current balance sheet exchange rates for the remeasurement of monetary assets and liabilities (e.g., cash, accounts receivable, accounts payable) and historical rates for the remeasurement of nonmonetary assets and liabilities (e.g., equity investments, deferred revenues) and related revenues, expenses, gains, and losses. Any exchange rate gains and losses from the remeasurement of monetary assets and liabilities should be reflected in the earnings of the foreign entities.

ASC Topic 830 does not clearly define monetary assets and liabilities, but the implementation guidance under ASC Topic 255, "Changing Prices," provides a comprehensive list of assets and liabilities, as well as their proper classification as either monetary or nonmonetary. (ASC 255-10-55-1 through -13 provide specific guidance for this classification.)

Translation of Foreign Entity Accounts

ASC Topic 830 defines translation as the process of expressing functional currency—if different from reporting currency—as reporting currency. ASC 830-30-45-12 requires that, subsequent to remeasurement, the financial statements of a foreign subsidiary be translated into the reporting entity's functional currency, and any gains and losses due to this translation be reflected in OCI in the equity section of the reporting company. This treatment contrasts with remeasurement (discussed previously), which reflects any exchange rate fluctuations in foreign-currency denominated accounts in earnings.

ASC 830-30-45-3 requires that the assets and liabilities of a foreign subsidiary be translated at the exchange rate prevailing at the balance sheet date, whereas revenues and expenses should be translated at the exchange rate that existed when these items were recognized. ASC 830-10-55-11, however, permits the use of average rates, instead of actual rates, for the translation of revenues and expenses, because the requirement of ASC 830-30-45-3 is very rigid and not practical in all instances. It is implicit in ASC Topic 830 that a foreign subsidiary's capital accounts (e.g., common stock, additional-paid-in-capital) should be translated at historical rates.

Intercompany accounts are an exception for translation purposes. ASC Topic 830 requires that any foreign exchange gains and losses on intercompany foreign currency accounts that are of a long-term investment nature be reported in OCI, whereas any gains and losses on intercompany accounts that are expected to be settled in the short term be recognized in earnings.

Equity Method Investment

ASC 830-10-15-5 requires that the foreign currency financial statements of a foreign investee that are accounted for under the equity method be translated into the functional currency of the reporting company. The process, similar to translation for consolidation of a foreign subsidiary, is as follows:

- First, the functional currency of the equity method investee must be determined.
- Second, the accounts denominated in currencies other than the functional currency of the investee must be remeasured; the result should be reflected in the earnings of the investee.

Finally, if the functional currency of the equity method investee is different from the functional currency of the investor (the reporting entity), the financial statements of the investee should be translated into the functional currency of the investor, and the result should be reflected as a CTA in OCI.

Provisions of ASU 2013-05

On March 5, 2013, FASB issued ASU 2013-05, which aimed to resolve the diversity in practice surrounding whether the provisions of ASC 810-10 or ASC 830-30 apply to the release of a CTA into earnings when a reporting entity either sells part or all of its investment in a foreign entity or no longer holds a controlling financial interest in a foreign entity.

In its November 2011 meeting, FASB's Emerging Issues Task Force (EITF) reached a consensus that companies should apply the deconsolidation and derecognition guidance in ASC Topic 810, "Consolidation," for releasing a CTA when a parent ceases to have a controlling financial interest in either a subsidiary or equity investment. Topic 810 provides guidance on the scope and type of entities subject to consolidation and the mechanism of their consolidation and deconsolidation. ASU 2013-05 did not change the definition of foreign subsidiary or functional currency, but it did change the guidance for the reclassification of CTAs from OCI into earnings when the percentage of ownership interest of a reporting company in a foreign subsidiary or investment changes. (The *Exhibit* summarizes the provisions of this guidance.)

ASU 2013-05 is effective prospectively for fiscal years (and interim periods) beginning after December 15, 2013 (December 15, 2014, for private companies). FASB permits early adoption of the guidance; entities electing to adopt early should apply this guidance as of the beginning of the fiscal year in which it is adopted.

The EITF concluded that a retrospective transition is not appropriate because CTA releases are related to nonrecurring events; as such, the cost of a retrospective transition would likely exceed any estimated comparability benefit.

Potential Impact

Businesses that invest in foreign entities should be cognizant of the provisions of this guidance and the possible impact it can have on earnings when the company changes its level of ownership interest in a foreign entity or foreign equity investment. Care should be taken to plan acquisitions and investments in order to minimize the possible negative impact of such a transaction in the reporting entity's earnings. ❑

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EXHIBIT

Provisions of Accounting Standards Update (ASU) 2013-05, *Foreign Currency Matters*

Triggering Event	Accounting
The parent company reduces its ownership interest in the foreign subsidiary and, as a result, loses control (e.g., percentage of ownership interest declines from 100% to 5%).	The cumulative translation adjustment (CTA) is released into earnings.[1]
The parent company reduces its ownership interest in the foreign subsidiary, yet retains control (e.g., percentage of ownership interest declines from 100% to 90%).	Pro rata share of the CTA is released into earnings, and the remainder is reflected in noncontrolling interest.
The parent company completely liquidates its ownership interest in the foreign subsidiary (i.e., percentage of ownership interest declines from 100% to 0%).	The CTA is released into earnings.
The reporting company sells part of its interest in a foreign equity investment but nevertheless maintains its significant influence (e.g., percentage of ownership interest declines from 40% to 30%).	Pro rata share of the CTA is released into earnings.
The parent company sells part of its interest in a foreign equity investment, loses significant influence, and changes from the equity method of accounting to the cost method (e.g., percentage of interest ownership declines from 40% to 5%).	Pro rata share of the CTA is released into earnings and the remainder becomes part of the cost method carrying value of the investment.
The parent company held an equity interest investment immediately prior to acquisition of a foreign subsidiary (e.g., percentage of ownership interest increases from 20% to 100% through step acquisition).[2]	The CTA related to equity investment is released into earnings.

[1] The guidance views this transaction as two distinct events: disposition of the subsidiary and subsequent acquisition of 5% investment.

[2] ASC 805-10-25-9 describes a step acquisition as a business combination where an acquirer had an equity investment in a foreign entity and subsequently obtains control of the foreign entity by increasing its percentage of ownership interest. In a step acquisition, the acquirer remeasures its gains and losses and reflects them in earnings. Therefore, in this example, all of the CTA related to equity investment in the foreign entity would be released into earnings as part of the remeasurement gain or loss recognition. The full release of CTA into earnings is based on the premise that the guidance views the original equity investment and subsequent acquisition as two distinct events.