

Statement of Financial Accounting Standards No. 52

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Foreign Currency Translation

December 1981



Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 52: Foreign Currency Translation

FAS 52 Summary

Application of this Statement will affect financial reporting of most companies operating in foreign countries. The differing operating and economic characteristics of varied types of foreign operations will be distinguished in accounting for them. Adjustments for currency exchange rate changes are excluded from net income for those fluctuations that do not impact cash flows and are included for those that do. The requirements reflect these general conclusions:

- The economic effects of an exchange rate change on an operation that is relatively self-contained and integrated within a foreign country relate to the net investment in that operation. Translation adjustments that arise from consolidating that foreign operation do not impact cash flows and are not included in net income.
- The economic effects of an exchange rate change on a foreign operation that is an extension of the parent's domestic operations relate to individual assets and liabilities and impact the parent's cash flows directly. Accordingly, the exchange gains and losses in such an operation are included in net income.
- Contracts, transactions, or balances that are, in fact, effective hedges of foreign exchange risk will be accounted for as hedges without regard to their form.

More specifically, this Statement replaces FASB Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*, and revises the existing accounting and reporting requirements for translation of foreign currency transactions and foreign currency financial statements. It presents standards for foreign currency translation that are designed to (1) provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity and (2) reflect in consolidated statements the financial results and relationships as measured in the primary currency in which each entity conducts its business (referred to as its "functional currency").

An entity's functional currency is the currency of the primary economic environment in which that entity operates. The functional currency can be the dollar or a foreign currency

depending on the facts. Normally, it will be the currency of the economic environment in which cash is generated and expended by the entity. An entity can be any form of operation, including a subsidiary, division, branch, or joint venture. The Statement provides guidance for this key determination in which management's judgment is essential in assessing the facts.

A currency in a highly inflationary environment (3-year inflation rate of approximately 100 percent or more) is not considered stable enough to serve as a functional currency and the more stable currency of the reporting parent is to be used instead.

The functional currency translation approach adopted in this statement encompasses:

- a. Identifying the functional currency of the entity's economic environment
- b. Measuring all elements of the financial statements in the functional currency
- c. Using the current exchange rate for translation from the functional currency to the reporting currency, if they are different
- d. Distinguishing the economic impact of changes in exchange rates on a net investment from the impact of such changes on individual assets and liabilities that are receivable or payable in currencies other than the functional currency

Translation adjustments are an inherent result of the process of translating a foreign entity's financial statements from the functional currency to U.S. dollars. Translation adjustments are not included in determining net income for the period but are disclosed and accumulated in a separate component of consolidated equity until sale or until complete or substantially complete liquidation of the net investment in the foreign entity takes place.

Transaction gains and losses are a result of the effect of exchange rate changes on transactions denominated in currencies other than the functional currency (for example, a U.S. company may borrow Swiss francs or a French subsidiary may have a receivable denominated in kroner from a Danish customer). Gains and losses on those foreign currency transactions are generally included in determining net income for the period in which exchange rates change unless the transaction hedges a foreign currency commitment or a net investment in a foreign entity. Intercompany transactions of a long-term investment nature are considered part of a parent's net investment and hence do not give rise to gains or losses.

INTRODUCTION

1. FASB Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*, was issued in October 1975 and was effective for fiscal years that began on or after January 1, 1976. In May 1978, the Board issued an invitation for public comment on Statements 1-12, each of which had been in effect for at least two years. **Foreign currency translation⁺** was the subject of most of the comments received. In January 1979, the Board added to its agenda a project to reconsider Statement 8. This Statement is the result of that project.

2. This Statement establishes revised standards of financial accounting and reporting for **foreign currency transactions** in financial statements of a **reporting enterprise** (hereinafter, **enterprise**). It also revises the standards for translating foreign currency financial statements (hereinafter, **foreign currency statements**) that are incorporated in the financial statements of an enterprise by consolidation, combination, or the equity method of accounting. **Translation** of financial statements from one currency to another for purposes other than consolidation, combination, or the equity method is beyond the scope of this Statement. For example, this Statement does not cover translation of the financial statements of an enterprise from its **reporting currency** into another currency for the convenience of readers accustomed to that other currency.

3. This Statement supersedes FASB Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*,¹ FASB Statement No. 20, *Accounting for Forward Exchange Contracts*, FASB Interpretation No. 15, *Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company*, and FASB Interpretation No. 17, *Applying the Lower of Cost or Market Rule in Translated Financial Statements*.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Objectives of Translation

4. Financial statements are intended to present information in financial terms about the performance, financial position, and cash flows of an enterprise. For this purpose, the financial statements of separate **entities** within an enterprise, 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 enterprise. 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 ² those assets, liabilities, revenues, expenses, gains, and losses that are measured or denominated in a **foreign currency**.³ However, the unity presented by such translation does not alter the underlying significance of the results and relationships of the constituent parts of the enterprise. It is only through the effective operation of its constituent parts that the enterprise as a whole is able to achieve its purpose. Accordingly, the translation of the financial statements of each component entity of an enterprise should accomplish the following objectives:

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

The Functional Currency

5. 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. Appendix A provides guidance for determination of the functional currency. The economic factors cited in Appendix A, and possibly others, should be considered both individually and collectively when determining the functional currency.

6. For an entity with operations that are relatively self-contained and integrated within a particular country, the functional currency generally would be the currency of that country. However, a foreign entity's functional currency might not be the currency of the country in which the entity is located. For example, the parent's currency generally would be the functional currency for foreign operations that are a direct and integral component or extension of the parent company's operations.

7. 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.

8. The functional currency (or currencies) of an entity is basically a matter of fact, but in some instances the observable facts will not clearly identify a single functional currency. 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 Board's stated objectives for foreign currency translation (paragraph 4). 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.

9. 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.

10. 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 process is intended to produce the same result as if the entity's books of record had been maintained in the functional currency. 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 this Statement (paragraphs 15 and 16). Appendix B provides guidance for remeasurement into the functional currency.

The Functional Currency in Highly Inflationary Economies

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 10. 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.

Translation of Foreign Currency Statements

12. All elements of financial statements shall be translated by using a **current exchange rate**. For assets and liabilities, the exchange rate at the balance sheet date shall be used. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used. 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.

13. 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 separately and accumulated in a separate component of equity.

14. 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 removed from the separate component of equity and shall be 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.

Foreign Currency Transactions

15. Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. 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. Likewise, a transaction gain or loss (measured from the **transaction date** or the most recent intervening

balance sheet date, whichever is later) realized upon settlement of a foreign currency transaction generally shall be included in determining net income for the period in which the transaction is settled. The exceptions to this requirement for inclusion in net income of transaction gains and losses are set forth in paragraphs 20 and 21 and pertain to certain intercompany transactions and to transactions that are designated as, and effective as, economic hedges of net investments and foreign currency commitments.

16. For other than **forward exchange contracts** (paragraphs 17-19), the following shall apply to all foreign currency transactions of an enterprise and its investees:

- a. At the date the transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date (paragraphs 26-28).
- b. 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.

Forward Exchange Contracts

17. A forward exchange contract (forward contract) is an agreement to exchange different currencies at a specified future date and at a specified rate (the **forward rate**). A forward contract is a foreign currency transaction. A gain or loss on a forward contract that does not meet the conditions described in paragraph 20 or 21 shall be included in determining net income in accordance with the requirements for other foreign currency transactions (paragraph 15). Agreements that are, in substance, essentially the same as forward contracts, for example, **currency swaps**, shall be accounted for in a manner similar to the accounting for forward contracts.

18. A gain or loss (whether or not deferred) on a forward contract, except a forward contract of the type discussed in paragraph 19, shall be computed by multiplying the foreign currency amount of the forward contract by the difference between the **spot rate** at the balance sheet date and the spot rate at the date of inception of the forward contract (or the spot rate last used to measure a gain or loss on that contract for an earlier period). The **discount or premium on a forward contract** (that is, the foreign currency amount of the contract multiplied by the difference between the contracted forward rate and the spot rate at the date of inception of the contract) shall be accounted for separately from the gain or loss on the contract and shall be included in determining net income over the life of the forward contract. However, if a gain or loss is deferred under paragraph 21, the forward contract's discount or premium that relates to the commitment period may be included in the measurement of the basis of the related foreign currency transaction when recorded. If a gain or loss is accounted for as a hedge of a net investment under paragraph 20, the forward contract's discount or premium may be included with translation adjustments in the separate component of equity.

19. A gain or loss on a speculative forward contract (that is, a contract that does not hedge an exposure) shall be computed by multiplying the foreign currency amount of the forward contract by the difference between the forward rate available for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). No separate accounting recognition is given to the discount or premium on a speculative forward contract.

Transaction Gains and Losses to Be Excluded from Determination of Net Income

20. 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 (paragraph 13):

- a. Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date
- b. Intercompany 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 enterprise's financial statements

21. A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction (for example, the purchase or the sale of the equipment). Losses shall not be deferred, however, if it is estimated that deferral would lead to recognizing losses in later periods. A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

- a. The foreign currency transaction is designated as, and is effective as, a hedge of a foreign currency commitment.
- b. The foreign currency commitment is firm.

The required accounting shall commence as of the designation date. The portion of a hedging transaction that shall be accounted for pursuant to this paragraph is limited to the amount of the related commitment. If a hedging transaction that meets conditions (a) and (b) above exceeds the amount of the related commitment, the gain or loss pertaining to the portion of the hedging transaction in excess of the commitment shall be deferred to the extent that the transaction is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized; consequently, it shall not be included in the aggregate transaction gain or loss disclosure required by paragraph 30. A gain or loss pertaining to the portion of a hedging transaction in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be

deferred. If a foreign currency transaction previously considered a hedge of a foreign currency commitment is terminated before the transaction date of the related commitment, any deferred gain or loss shall continue to be deferred and accounted for in accordance with the requirements of this paragraph.

Income Tax Consequences of Rate Changes

22. Interperiod tax allocation is required in accordance with APB Opinion No. 11, *Accounting for Income Taxes*, if taxable exchange gains or tax-deductible exchange losses resulting from an entity's foreign currency transactions are included in net income in a different period for financial statement purposes from that for tax purposes.

23. Translation adjustments shall be accounted for in the same way as timing differences under the provisions of APB Opinions 11, 23, and 24. APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*, provides that deferred taxes shall not be provided for unremitted earnings of a subsidiary in certain instances; in those instances, deferred taxes shall not be provided on translation adjustments.

24. Opinion 11 requires income tax expense to be allocated among income before extraordinary items, extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other equity accounts. Some transaction gains and losses and all translation adjustments are reported in a separate component of equity. Any income taxes related to those transaction gains and losses and translation adjustments shall be allocated to that separate component of equity.

Elimination of Intercompany Profits

25. The elimination of intercompany profits that are attributable to sales or other transfers between entities that are consolidated, combined, or accounted for by the equity method in the enterprise'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.

Exchange Rates

26. The exchange rate is 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. If exchangeability between two currencies is temporarily lacking at the transaction date or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Statement. 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 enterprise shall be carefully considered (ARB 43, Chapter 12, paragraph 8).

27. The exchange rates to be used for translation of foreign currency transactions and foreign

currency statements are as follows:

- a. *Foreign Currency Transactions*—The applicable rate at which a particular transaction could be settled at the transaction date shall be used to translate and record the transaction. 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.
- b. *Foreign Currency Statements*—In the absence of unusual circumstances, the rate applicable to **conversion** of a currency for purposes of dividend remittances shall be used to translate foreign currency statements.⁴

28. If a foreign entity whose balance sheet date differs from that of the enterprise is consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise, the current rate is the rate in effect at the foreign entity's balance sheet date for purposes of applying the requirements of this Statement to that foreign entity.

Use of Averages or Other Methods of Approximation

29. Literal application of the standards in this Statement 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, the propriety of using average rates to translate revenue and expense amounts is noted in paragraph 12. Likewise, the use of other time- and effort-saving methods to approximate the results of detailed calculations is permitted.

Disclosure

30. The aggregate transaction gain or loss included in determining net income for the period shall be disclosed in the financial statements or notes thereto. For that disclosure, gains and losses on forward contracts determined in conformity with the requirements of paragraphs 18 and 19 shall be considered transaction gains or losses. Certain enterprises, 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 Statement, they may be disclosed as dealer gains or losses rather than as transaction gains or losses.

31. An analysis of the changes during the period in the separate component of equity for cumulative translation adjustments shall be provided in a separate financial statement, in notes to the financial statements, or as part of a statement of changes in equity. At a minimum, the analysis shall disclose:

- a. Beginning and ending amount of cumulative translation adjustments
- b. The aggregate adjustment for the period resulting from translation adjustments (paragraph 13) and gains and losses from certain hedges and intercompany balances (paragraph 20)
- c. The amount of income taxes for the period allocated to translation adjustments (paragraph

24)

- 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 (paragraph 14)

32. An enterprise's financial statements shall not be adjusted for a rate change that occurs after the date of the enterprise'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 enterprise. However, disclosure of the rate change and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary.

Effective Date and Transition

33. This Statement shall be effective for fiscal years beginning on or after December 15, 1982, although earlier application is encouraged. The initial application of this Statement shall be as of the beginning of an enterprise's fiscal year. Financial statements for fiscal years before the effective date, and financial summaries or other data derived therefrom, may be restated to conform to the provisions of paragraphs 5-29 of this Statement. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per-share amounts for each fiscal year restated. If the prior year is not restated, disclosure of income before extraordinary items and net income for the prior year computed on a pro forma basis is permitted.

34. The effect of translating all of a foreign entity's assets and liabilities from a foreign functional currency into the reporting currency at the current exchange rate as of the beginning of the year for which this Statement is first applied shall be reported as the opening balance of the cumulative translation adjustments component of equity. The effect of remeasuring a foreign entity's deferred income taxes and life insurance policy acquisition costs at the current exchange rate (paragraph 54) as of the beginning of the year for which this Statement is first applied shall be reported as an adjustment of the opening balance of retained earnings.

35. Amounts deferred on forward contracts that (a) under Statement 8 were accounted for as hedges of identifiable foreign currency commitments to receive proceeds from the use or sale of nonmonetary assets translated at historical rates, and (b) are canceled at the time this Statement is first applied, shall be included in the opening balance of the cumulative translation adjustments component of equity up to the amount of the offsetting adjustment attributable to those nonmonetary assets.

36. Financial statements for periods beginning on or after the effective date of this Statement shall include the disclosures specified by paragraphs 30-32. To the extent practicable, those disclosures shall also be included in financial statements for earlier periods that have been restated pursuant to paragraph 33.

37. Financial statements of enterprises that first adopt this standard for fiscal years ending on or before March 31, 1982 shall disclose the effect of adopting the new standard on income before extraordinary items, net income, and related per-share amounts for the year of the change. Those disclosures are not required for financial statements of enterprises that first adopt this standard for subsequent fiscal years.

38. The Board expects to issue an Exposure Draft proposing an amendment of FASB Statement No. 33, *Financial Reporting and Changing Prices*, to be consistent with the functional currency approach to foreign currency translation. Prior to issuance of a final amendment of Statement 33, enterprises that adopt this Statement and that are subject to the requirements of Statement 33 shall have either of the following options:

- a. They may prepare the supplementary information based on this Statement and on the proposed amendment of Statement 33.
- b. They may prepare the supplementary information based on the application of Statement 8 and on the provisions of existing Statement 33. (Under this option, historical cost information based on the application of Statement 8 shall be presented in the supplementary information for comparison with the constant dollar and current cost information.)

Enterprises that would become subject to the requirements of Statement 33 as a result of adopting this Statement are exempt from the requirements of Statement 33 until the effective date of this Statement.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Block, Kirk, and Morgan dissented.

Messrs. Block, Kirk, and Morgan dissented to the issuance of this Statement. They start from a premise different from that underlying this Statement. They believe that more meaningful consolidated results are attained by measuring costs, cost recovery, and exchange risk from a dollar perspective rather than from multiple functional currency perspectives. Accordingly, the dissenters do not believe that this Statement improves financial reporting. In their opinion, improved financial reporting would have resulted from an approach that:

- a. Adopted objectives of translation that retained the concept of a single consolidated entity and a single unit of measure (that is, all elements of U.S. consolidated financial statements would be measured in dollars rather than multiple functional currencies)
- b. Avoided creating direct entries to equity
- c. Essentially retained Statement 8's translation method, with an exception being translation of locally sourced inventory at the current rate

- d. Recognized all gains and losses in net income (that is, no separate and different accounting for transaction gains or losses and translation adjustments), but allowed for a separate and distinct presentation of those gains and losses within the income statement
- e. Recognized additional contractual arrangements (for example, operating leases and take-or-pay contracts) that effectively hedged an exposed net monetary liability position

The dissenters recognize that such an approach would not satisfy all of the critics of Statement 8, but they believe it would have avoided the more far-reaching implications of the functional currency theory. They acknowledge that translating certain inventories at current rates departs from historical cost in dollars. However, they would accept that departure on pragmatic grounds as part of a solution to an exceedingly difficult problem.

As further discussed in subsequent paragraphs, the dissenting Board members do not support this Statement because in their opinion it:

- a. Builds on two incompatible premises and, as a result, produces anomalies and a significant but unwarranted reporting distinction between transaction gains and losses and translation adjustments
- b. Adopts objectives and methods that are at variance with fundamental concepts that underlie present financial reporting
- c. Incorrectly assumes that an aggregation of the results of foreign operations measured in functional currencies and *expressed* in dollars, rather than consolidated results *measured* in dollars, assists U.S. investors and creditors in assessing future cash flows to them
- d. Will not result in similar accounting for similar circumstances

Incompatibility of Underlying Premises

The standards for translating foreign currency financial statements set forth in this Statement stem from two premises that are incompatible with each other. The first premise is that it is a parent company's net investment in a foreign operation that is subject to exchange rate risk rather than the foreign operation's individual assets and liabilities. The second premise is that translation should retain the relationships in foreign currency financial statements as measured by the functional currency. The premise of a parent company's exposed net investment reflects a dollar perspective of exchange rate risk, and that calls for a dollar measure of the effects of exchange rate changes. The premise of retaining the relationships of measurements in functional currency financial statements calls for a functional currency measure of the effects of exchange rate changes.

The dissenting Board members note that although the translation process can retain certain intraperiod relationships reported in functional currency financial statements, it cannot retain interperiod functional currency relationships when exchange rates change. Further, when an exchange rate changes between the dollar and a foreign currency, the value of any holdings of that currency changes and, from a dollar perspective, the resulting gain or loss is either real, or unreal, in its entirety. However, to implement the functional currency perspective, the standards

result in a division of that gain or loss into two components. One is considered in measuring consolidated net income and the other is considered a translation adjustment. Thus, the standards require a transaction gain in income on a foreign operation's holdings of a third currency when that currency strengthens in relation to the functional currency, even if the third currency has weakened in terms of dollars. That gain will be reported in consolidated net income despite the fact that it does not exist in dollar terms and can never provide increased dollar cash flows to U.S. investors and creditors. The standards inherently recognize that fact by requiring a compensating debit translation adjustment. (Examples that further illustrate these concerns are contained in paragraphs 111-113 of the August 28, 1980 Exposure Draft, *Foreign Currency Translation*.)

The dissenters believe that the need for a translation adjustment that adjusts consolidated equity to the same amount as would have resulted had all foreign currency transactions of foreign operations been measured in dollars demonstrates the incompatibility of the two underlying premises. They believe that incompatibility is further demonstrated by the differing views of the nature of translation adjustments described in paragraphs 113 and 114. In the dissenters' opinion, translation adjustments are, from a dollar perspective, gains and losses as defined in FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, which should be reported in net income when exchange rates change. The dissenters believe that from a functional currency perspective, translation adjustments fail to meet any definition of an element of financial statements because they do not exist in terms of functional currency cash flows.

Relationship to Preexisting Fundamental Concepts

The dissenters believe the two premises underlying this Statement (discussed above) challenge and reject the dollar perspective that underlies existing theories of historical cost and capital maintenance, inflation accounting, consolidation, and realization. The rejection of the dollar perspective has ramifications far beyond this project and was unnecessary in a translation project.

While not explicitly stated, today's accounting model includes the capital maintenance concept that income of a consolidated U.S. entity exists only after recovery of historical cost measured in dollars. For example, prior to this Statement, the gain on the sale by a foreign operation of an internationally priced inventory item or a marketable security would have been measured by comparing the dollar equivalent sales price with the fixed dollar equivalent historical cost of the item. This Statement changes that. It remeasures the dollar equivalent cost while the item is held (measured by changes in the exchange rate between the foreign currency and the dollar) and treats that remeasurement as a translation adjustment, seldom if ever to be reported in net income. Under this Statement, consolidated net income, although expressed in dollars, does not represent the measure of income after maintaining capital measured in dollars. The dissenters believe that U.S. investors' and creditors' decisions are based on a dollar perspective of capital maintenance. Not only does this Statement change income measurement and capital maintenance concepts in the primary financial statements but it also implies the need to modify the measurement of changes in current costs (sometimes referred to as holding gains

or losses) in Statement 33 and, likewise, to change that Statement's requirements for constant dollar accounting to constant functional currency accounting.

This Statement abandons the long-standing principle that consolidated results should be measured from a single perspective rather than multiple perspectives. The dissenters believe (for the reasons set forth in paragraphs 83-95 of Statement 8) that a single perspective is essential for (a) valid addition and subtraction in the measurement of financial position and periodic net income and (b) the understandability and representational faithfulness of consolidated results presented in dollars and described as being prepared on the historical cost basis. The dissenters believe that readers of financial statements are better served by having consolidated financial statements prepared in terms of a common bench mark—a single unit of measure. This means to the dissenters that the translation process is one of remeasurement of the individual items of foreign financial statements (not net investments) into dollars—much in the same way as Statement 33 presently requires a remeasurement of individual items of financial statements (not net investments) from nominal dollar measures into constant dollars.

The Statement introduces a concept of realization (paragraphs 71, 111, 117, and 119) different from any previously applied in consolidated financial statements. It requires the results of foreign operations to be measured in various functional currencies and then translated into dollars and included in consolidated net income. It defers recognizing in net income the effects of exchange rate changes from a dollar perspective on the individual assets and liabilities of those same foreign operations until an indefinite future period that will almost always be beyond the point in time that those individual assets and liabilities have ceased to exist. As a result, the dollar effects of a rate change on current operating revenues are recognized when they occur by reporting in the translated income statement an increased or decreased dollar equivalent for those revenues versus the dollar equivalent of identical revenues generated before the rate change. However, the effects of the same rate change on the uncollected receivables from those previous revenue transactions are not included in net income until liquidation of the foreign operation. By not recognizing in net income the effects of exchange rate changes on existing receivables, this Statement results in sales denominated in a foreign currency being accounted for as if they had been denominated in dollars. That result is a focal point of the criticism made in this Statement (paragraph 75) about Statement 8. However, unlike this Statement, Statement 8 recognized that foreign currency sales are not denominated in dollars and therefore it required that the effects of exchange rate changes on all foreign currency denominated receivables be recognized in net income. To do otherwise places the enterprise in the anomalous position of having recognized the entire effect of the rate change on a current transaction while holding in suspense its effect on a previous transaction until liquidation of the foreign operation.

This Statement accepts the use of the Statement 8 methodology (that is, using the dollar as the functional currency) for some foreign operations (including all operations in highly inflationary economies), but at the same time criticizes that methodology. It asserts that the Statement 8 methodology results in accounting as if all transactions were conducted in the economic environment of the United States and in dollars (paragraphs 74, 75, and 86). The dissenters believe such views were convincingly rebutted in paragraphs 94 and 95 of Statement 8, as follows:

Some respondents to the Exposure Draft criticized that objective as an attempt to account for local and foreign currency transactions of foreign operations as if they were dollar transactions or, to a few respondents, as if they were dollar transactions in the United States. In the Board's judgment, those criticisms are not valid. Neither the objective nor the procedures to accomplish it change the denomination of a transaction or the environment in which it occurs. The procedures adopted by the Board are consistent with the purpose of consolidated financial statements. The foreign currency transactions of an enterprise and the local and foreign currency transactions of its foreign operations are translated and accounted for as transactions of a single enterprise. The denomination of transactions and the location of assets are not changed; however, the separate corporate identities within the consolidated group are ignored. Translation procedures are merely a means of remeasuring in dollars amounts that are denominated or originally measured in foreign currency. That is, the procedures do *not* attempt to simulate what the cost of a foreign plant would have been had it been located in the United States; instead, they recognize the factors that determined the plant's cost in the foreign location and express that cost in dollars.

If translation procedures were capable of changing the denomination of an asset or liability from foreign currency to dollars, no exchange risk would be present.

Effects on Cash Flow Assessments

The dissenters believe that U.S. investors and creditors should be provided with information about a multinational enterprise's performance measured in dollars because that is the currency in which, ultimately, the enterprise makes cash payments to them. Foreign exchange exposure to a U.S. investor or creditor is the exposure to increased or decreased potential dollar cash flows caused by changes in exchange rates between foreign currencies and the dollar. Changes in exchange rates between two foreign currencies are not relevant, except to the extent that each such foreign currency's exchange rate for the dollar changes.

Supporting the functional currency perspective is the assenters' view (paragraphs 73, 75, 97, and elsewhere) that a translated functional currency income statement better provides U.S. investors and creditors with information necessary in assessing future cash flows than does an income statement whose components have been measured from a dollar perspective. The dissenting view is that a translated functional currency income statement is inappropriate because it can include items that (a) do not exist for the consolidated enterprise (for example, transaction gains on intercompany trade receivables or monetary items denominated in dollars) or (b) are incorrectly measured (for example, a gain on a holding of a third currency that significantly strengthens against the dollar but only moderately strengthens against the functional currency). It can also exclude items that do exist for the consolidated enterprise (for example, a gain on a monetary asset denominated in a foreign operation's functional currency when that currency strengthens against the dollar).

The dissenters see no persuasive reasoning to support the belief that external users want

or need to know the amount of transaction gains or losses as measured from the perspective of the manager of the foreign operation (that is, in functional currency), while at the same time wanting a balance sheet that is measured from a dollar perspective—a balance sheet that denies the usefulness of the foreign perspective. (The previously referenced examples in the August 1980 Exposure Draft also further illustrate this concern.)

Similar Accounting for Similar Circumstances

The dissenters believe that the criteria in paragraph 42 for deciding between the Statement 8 translation method and the current rate method are inappropriate (for the reasons set forth in paragraphs 140-151 of Statement 8). They also believe that application of those criteria will not result in similar accounting for similar situations.

Likewise, the absence of effective criteria that would objectively indicate when foreign currency transactions (paragraph 20(a)) and forward exchange contracts (paragraph 21) are hedges creates the possibility that transaction gains or losses that should be reported in net income currently may instead be reported as translation adjustments or deferred as hedges of commitments.

The variety of permissible methods of transition from the existing Statement 8 requirements may also result in similar circumstances being accounted for differently. Mr. Morgan believes the transition paragraphs should have required that the amount necessary to adjust from the Statement 8 basis to the new basis be reported as the opening translation adjustment in equity for the first year in which the new Statement becomes effective. To restate any year prior to the effective date of this Statement may foster an inappropriate conclusion, namely, that those restated results are the results an entity might have experienced had the new Statement been in effect for earlier periods. There is considerable evidence that many enterprises alter their hedging of foreign exchange exposure depending on the accounting standards currently in effect. Thus, restated financial statements for those entities, whether required or done voluntarily, could not accurately reflect what might have happened had this Statement been in effect. Voluntary restatement also diminishes the comparability of financial reporting among companies. In Mr. Morgan's view, the Board should have prohibited restatement as a method of transition to this new Statement.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*

Frank E. Block

John W. March

Robert A. Morgan

David Mosso

Robert T. Sprouse

Ralph E. Walters

Appendix A: DETERMINATION OF THE FUNCTIONAL CURRENCY

39. An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. The 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.

40. 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.

41. The Board has developed, with significant input from its task force and other advisors, the following general guidance on 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 in order 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 4. 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.

42. The salient economic factors set forth below, and possibly others, should be considered both individually and collectively when determining the functional currency.

a. Cash flow indicators

- (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 impact the parent company's cash flows.
- (2) Parent's Currency—Cash flows related to the foreign entity's individual assets and liabilities directly impact the parent's cash flows on a current basis and are readily available for remittance to the parent company.

b. Sales price indicators

- (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
 - (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
 - (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, on a continuing basis, are primarily costs for components obtained from the country in which the parent company is located.
- e. Financing indicators
 - (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 company. Infusion of additional funds from the parent company 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. Intercompany transactions and arrangements indicators
 - (1) Foreign Currency—There is a low volume of intercompany transactions and there is not an extensive interrelationship between the operations of the foreign entity and the parent company. 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 intercompany transactions and there is an extensive interrelationship between the operations of the foreign entity and the parent company. 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, etc., that could readily be carried on the parent's or an affiliate's books.

43. 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-company-produced products and another operation that manufactures and sells foreign-entity-produced products. If those two operations 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 circumstances such as those described

above, each operation may be considered to be an entity as that term is used in this Statement; and, based on the facts and circumstances, each operation might have a different functional currency.

44. Foreign investments that are consolidated or accounted for by the equity method are controlled by or subject to significant influence by the parent company. Likewise, the parent's currency is often used for measurements, assessments, evaluations, projections, etc., 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.

45. Once a determination of the functional currency is made, that decision shall be consistently used for each foreign entity unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. (APB Opinion No. 20, *Accounting Changes*, paragraph 8, states that "adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring" is not a change in accounting principles.)

46. If the functional currency changes from a foreign currency to the reporting currency, translation adjustments for prior periods should 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. 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 should be reported in the cumulative translation adjustments component of equity.

Appendix B: REMEASUREMENT OF THE BOOKS OF RECORD INTO THE FUNCTIONAL CURRENCY *

Introduction

47. Paragraph 12 of this Statement requires that all of a foreign entity's assets and liabilities shall be translated from the entity's functional currency into the reporting currency using the current exchange rate. Paragraph 12 also requires that revenues, expenses, gains, and losses be translated using the rates on the dates on which those elements are recognized during the period. The specified result can be reasonably approximated by using an appropriately weighted average exchange rate for the period. If an entity's books of record are not maintained in its functional currency, this Statement (paragraph 10) requires remeasurement into the functional currency

prior to the translation process. If a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation. The remeasurement process should produce the same result as if the entity's books of record had been initially recorded 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 appendix 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).

48. The table below lists common nonmonetary balance sheet items and related revenue, expense, gain, and loss accounts that should be remeasured using historical rates in order to produce the same result in terms of the functional currency that would have occurred if those items had been initially recorded in the functional currency.

Accounts to Be Remeasured Using Historical Exchange Rates

Marketable securities carried at cost

- Equity securities
- Debt securities not intended to be held until maturity

Inventories carried at cost

Prepaid expenses such as insurance, advertising, and rent

Property, plant, and equipment

Accumulated depreciation on property, plant, and equipment

Patents, trademarks, licenses, and formulas

Goodwill

Other intangible assets

Deferred charges and credits, except deferred income taxes and policy acquisition costs for life insurance companies

Deferred income

Common stock

Preferred stock carried at issuance price

Examples of revenues and expenses related to nonmonetary items:

Cost of goods sold

Depreciation of property, plant, and equipment

Amortization of intangible items such as goodwill, patents, licenses, etc.

Amortization of deferred charges or credits except deferred income taxes and
policy acquisition costs for life insurance companies

Inventories—Applying the Rule of Cost or Market, Whichever Is Lower, to Remeasure Inventory Not Recorded in the Functional Currency

49. The rule of cost or market, whichever is lower (as described in Statement 6 of Chapter 4, "Inventory Pricing," of ARB 43), 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 **5** 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.

50. Literal application of the rule of cost or market, whichever is lower, may require an inventory write-down **6** in functional currency financial statements for locally acquired inventory **7** if the value of the currency in which the books of record are maintained has declined in relation to the functional currency between the date the inventory was acquired and the date of the balance sheet. Such a write-down may not be necessary, however, if the replacement costs or selling prices expressed in the currency in which the books of record are maintained have increased sufficiently so that market exceeds historical cost as measured in functional currency. Paragraphs 51-53 illustrate this situation.

51. Assume the following:

- a. When the rate is $BR^*1 = FC2.40$, a foreign subsidiary of a U.S. company purchases a unit of inventory at a cost of BR500 (measured in functional currency, FC1,200).
- b. At the foreign subsidiary's balance sheet date, the current rate is $BR1 = FC2.00$ and the current replacement cost of the unit of inventory is BR560 (measured in functional currency, FC1,120).
- c. Net realizable value is BR630 (measured in functional currency, FC1,260).

- d. Net realizable value reduced by an allowance for an approximately normal profit margin is BR550 (measured in functional currency, FC1,100).

Because current replacement cost as measured in the functional currency (FC1,120) is less than historical cost as measured in the functional currency (FC1,200), an inventory write-down of FC80 is required in the functional currency financial statements.

52. Continue to assume the same information in the preceding example but substitute a current replacement cost at the foreign subsidiary's balance sheet date of BR620. Because market as measured in the functional currency ($\text{BR620} \times \text{FC2.00} = \text{FC1,240}$) exceeds historical cost as measured in the functional currency ($\text{BR500} \times \text{FC2.40} = \text{FC1,200}$), an inventory write-down is not required in the financial statements.

53. As another example, assume the information in paragraph 51, except that selling prices in terms of the currency in which the books of record are maintained have increased so that net realizable value is BR720 and net realizable value reduced by an allowance for an approximately normal profit margin is BR640. In that case, because replacement cost measured in functional currency ($\text{BR560} \times \text{FC2.00} = \text{FC1,120}$) is less than net realizable value reduced by an allowance for an approximately normal profit margin measured in functional currency ($\text{BR640} \times \text{FC2.00} = \text{FC1,280}$), market is FC1,280. Because market as measured in the functional currency (FC1,280) exceeds historical cost as measured in the functional currency ($\text{BR500} \times \text{FC2.40} = \text{FC1,200}$), an inventory write-down is not required in the functional currency financial statements.

Deferred Taxes and Policy Acquisition Costs

54. Statement 8 required certain deferred taxes that do not relate to assets or liabilities translated at current rates to be translated at historical rates. ⁸ Interpretation 15 required unamortized policy acquisition costs of a stock life insurance company to be translated at historical rates. ⁹ In Statement 33, the Board decided that, because of the close relationship of those accounts to related monetary items, a monetary classification should be used for the purposes of constant dollar accounting. For similar reasons, the Board decided to retain the classification required by Statement 33 for the purposes of remeasurement of an entity's books of record into its functional currency.

Appendix C

BASIS FOR CONCLUSIONS

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Appendix C: BASIS FOR CONCLUSIONS

Introduction

55. This appendix reviews considerations that were deemed significant by members of the Board in reaching the conclusions in this Statement. The Board members who assented to this Statement did so on the basis of the overall considerations; individual members gave greater weight to some factors than to others.

Nature of the Problem

56. Operations and transactions of an enterprise are affected by the changing prices of goods and services it buys and sells relative to a unit of currency, which is usually also the measuring unit for financial reporting.

57. If the enterprise operates in more than one currency environment, it is affected by the changing prices of goods and services in more than one economic environment and, additionally, by changes in relative prices among the several units of currency in which it conducts its business.

58. The accounting model, generally referred to as the historical cost model, does not generally recognize the effect of changing prices of goods and services until there has been an exchange transaction, usually a sale or purchase. In general, then, it does not recognize unrealized holding gains resulting from changes in the price of goods and services relative to the unit of currency.

59. For enterprises conducting activities in more than a single currency, the practical necessities of financial reporting in a single currency require that the changing prices between two units of currency be accommodated in some fashion. People generally agree on this practical necessity but disagree on concepts and details of implementation. As a result, there is significant disagreement among informed observers regarding the basic nature, information content, and meaning of results produced by various methods of translating amounts from foreign currencies into the reporting currency. Each method has strong proponents and severe critics.

60. In dealing with this dilemma, the Board was faced with the following basic choices:

- a. Changing the accounting model to one that recognizes currently the effects of all changing prices in the primary financial statements

- b. Deferring any recognition of changing currency prices until they are realized by an actual exchange of foreign currency into the reporting currency
- c. Recognizing currently the effect of changing currency prices on the carrying amounts of designated foreign assets and liabilities
- d. Recognizing currently the effect of changing currency prices on the carrying amounts of all foreign assets and liabilities

61. Alternative (a) runs counter to the Board's approach in Statement 33, which fosters experimentation with supplemental reporting to test the feasibility, usefulness, and cost of various techniques for reporting the effects of changing prices. Accordingly, the Board did not consider a change in the primary financial statement model to be a reasonable alternative for this project on foreign currency translation.

62. Alternative (b) has little or no support from the Board or its constituents. All transactions and balances would be translated at historical exchange rates—a formidable clerical task—until conversion to the parent's currency occurred. Postponing recognition would fail to reflect the effects of possibly very significant economic events at the time they occurred, particularly those that affect transactions that must be settled under changed currency prices. Most would consider this a retreat rather than an advance toward more useful financial reporting.

63. Alternative (c) is the approach taken in Statement 8. Although some believe this approach is conceptually consistent with the historical cost model, others do not agree. In any event, this approach has produced results that the Board and many constituents believe do not reflect the underlying economic reality of many foreign operations and thereby produces results that are not relevant. A summary of the more common criticisms of Statement 8 is included in paragraphs 153-156 of Appendix D.

64. Some constituents urged the Board to introduce a selective departure from the rationale of Statement 8 by simply adding selected assets to or deleting selected liabilities from the list of those for which the effect of changing currency prices is currently recognized under Statement 8. The most frequent proposals would translate all or some portion of inventory at current exchange rates. This approach would reduce the reported exchange gains and losses of many enterprises, but it would increase the reported exchange gains and losses of other enterprises. It would do nothing to lessen the impact of temporal method gains and losses on enterprises that have no significant amounts of inventory, such as financial institutions; nor would it resolve problems caused by large amounts of debt-financed property, plant, and equipment. Thus, it is not a general cure for the cited deficiencies and it has little or no conceptual basis.

65. Those who advocate a limited modification to translate inventories at the current rate generally oppose translating property, plant, and equipment and other nonmonetary assets on the same basis. As a result, depreciation allocated to inventory and cost of sales would be translated at the current rate, while depreciation allocated directly to expense would be translated at historical rates. This is inconsistent in concept and result. In the absence of any conceptual

distinction among nonmonetary items, the list of modifications would be subject to requests for continuous revisions that could be assessed only on an arbitrary, ad hoc basis. Selective modifications of Statement 8 were rejected by the Board primarily on those grounds.

66. The Board decided that, of the practical alternatives available to it, alternative (d) has the most conceptual merit, particularly for foreign operations that are reasonably self-contained. It will result in reports of financial condition and results of operations that, within the constraints of the historical cost model, will most closely reflect economic effects.

67. The problem is complicated by the fact that foreign operations differ greatly in structure and substance. In some situations, only certain assets and liabilities are exposed to foreign exchange risk, whereas in others the entire foreign operation or net investment is exposed to foreign exchange risk. These differences can significantly change the economic effect of exchange rate fluctuations.

68. The Board agreed that these variations in economic facts and circumstances should be recognized to the degree it is practical to do so and, accordingly, settled on the functional currency approach to translation as one that accommodates alternative (d) above, but recognizes situational differences. The nature of these differences and guidance for identifying the functional currency appears in paragraphs 41 and 42 of Appendix A.

69. A feature of the functional currency approach is the current rate translation method. The Board recognizes that the current rate method, although common in some other countries, has not been extensively used in the United States. Based on extensive study and due process, however, the Board believes that the functional currency approach best recognizes the substantive differences among foreign operations and best reflects the underlying economic effects of exchange rate changes in the consolidated financial statements. The functional currency approach encompasses:

- a. Identifying the functional currency of the entity's economic environment
- b. Measuring all elements of the financial statements in the functional currency
- c. Using the current exchange rate for translation from the functional currency to the reporting currency, if they are different
- d. Distinguishing the economic impact of changes in exchange rates on a net investment from the impact of such changes on individual assets and liabilities that are receivable or payable in currencies other than the functional currency

Objectives of Translation

70. The functional currency approach was adopted after considering the following objectives of foreign currency translation:

- a. To provide information that is generally compatible with the expected economic effects of a

- rate change on an enterprise's cash flows and equity
- b. To present the consolidated financial statements of an enterprise in conformity with U.S. generally accepted accounting principles
- c. To reflect in consolidated financial statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies
- d. To use a "single unit of measure" for financial statements that include translated foreign amounts

71. Objective (a), to provide information that is generally compatible with the expected economic effects of a rate change, was adopted by the Board as the basic objective. This was responsive to the pervasive criticism that translation results under Statement 8 do not reflect the underlying reality of foreign operations. The Board focused on two aspects of accounting results and their compatibility with the economic effects of a rate change—changes in equity and cash flow consequences. Compatibility in terms of effect on equity is achieved, for example, if an exchange rate change that is favorable to an enterprise's exposed position produces an accounting result that increases equity. Compatibility in terms of cash flow consequences is achieved if rate changes that are reasonably expected to impact either functional or reporting currency cash flows are reflected as gains or losses in determining net income for the period, and the effect of rate changes that have only remote and uncertain implications for realization are excluded from determining net income for the period.

72. The Board believes that objective (b), conformity with U.S. generally accepted accounting principles, is implicit in and basic to the purpose of all the Board's activities on every technical project and need not be singled out as a separate objective for foreign currency translation.

73. The primary focus of financial reporting is information about an enterprise's performance provided by measures of income and its components. Those who are concerned with the prospects for net cash flows are especially interested in that information. ¹⁰ The prospects for net cash flows of a foreign entity are necessarily derived from its performance in terms of transactions and events that occur in its functional currency; in turn, prospects for net cash flows to the consolidated enterprise from the foreign entity are necessarily derived from reinvestment of those functional currency net cash flows or their conversion and distribution. Accordingly, the Board believes that the performance of a foreign entity is best measured by U.S. generally accepted accounting principles applied in terms of the functional currency in which the entity primarily conducts its business, generates and expends cash, and reinvests or converts and distributes cash to its parent.

74. The purpose of translating the functional currency to the reporting currency, if the two are different, is to restate the functional currency financial statements in terms of the reporting currency for inclusion in consolidated financial statements. The process should retain the financial results and relationships that were created in the economic environment of the foreign operations; it should not remeasure individual financial statement elements as if the operations had been conducted in the economic environment of the reporting currency. Only by retaining

the functional currency relationships of each operating entity is it possible to portray aggregate performance in different operating environments for purposes of consolidation. Accordingly, in addition to adopting objective (a), the Board also adopted objectives (b) and (c) in combination.

75. Objective (d), to use a "single unit of measure" (for example, the dollar) for financial statements that include translated amounts, is the stated premise of the temporal method set forth in Statement 8. In the Board's view, that premise reflects in consolidated financial statements the transactions of the entire group, including foreign operations, as though all operations were extensions of the parent's domestic activities and all transactions were conducted and measured in the parent's reporting currency. That premise does not recognize that the assets, liabilities, and operations of foreign entities frequently exist, in fact, in other economic and currency environments and produce and consume foreign currency cash flows in those other environments. By requiring all foreign currency transactions to be remeasured as if they all had occurred in dollars, the "single unit of measure" approach obscures the fact that foreign entities acquire assets, incur and settle liabilities, and otherwise conduct their operations in multiple foreign currencies. Foreign operations are frequently conducted exclusively in foreign currencies, and the flow of dollars to the parent enterprise is dependent upon the foreign currency net cash flows generated by the foreign entity and remitted to the parent. Because it does not accord with relevant economic facts, reliance on a "single unit of measure" is not always compatible with the nature of foreign operations that is described and discussed in subsequent sections of this basis for conclusions. Accordingly, objective (d) was not adopted.

76. The Board also believes that, to the extent practicable, the accounting for the translation of foreign currency transactions and financial statements in the United States should harmonize with related accounting practices followed in other countries of the world. The Board maintained close liaison with representatives of the International Accounting Standards Committee and the accounting standards-setting bodies in Canada and the United Kingdom and Ireland as this Statement was developed. Representatives from each of those groups were active participants with the Board's foreign currency task force. The Accounting Standards Committee in the United Kingdom and Ireland has issued a proposed standard for foreign currency translation that is compatible with the standards set forth in this Statement.

The Functional Currency

77. 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.

78. The Board believes that the most meaningful measurement unit for the assets, liabilities, and operations of an entity is the currency in which it primarily conducts its business, assuming that currency has reasonable stability.

79. Multinational enterprises 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. In order to fulfill the objectives adopted by the Board, it is necessary to recognize at least two broad classes of foreign operations.

80. 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 upon 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.

81. In the second class are foreign operations that are primarily a direct and integral component or extension of the parent company's operations. Significant assets may be acquired from the parent enterprise 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 company in the parent's currency. For this class, the dollar is the functional currency.

82. The Board recognizes that some foreign operations will not fit neatly in either of the two broad classes described in paragraphs 80 and 81. Management's judgment will be required in order to select the functional currency in those instances. Guidance for management in this process is included in Appendix A.

83. Experience with Statement 8, responses to both Exposure Drafts, and testimony at the public hearing repeatedly evidenced that no translation method can yield reliable or economically credible results if it fails to recognize differences in economic substance among different foreign currency operations. Statement 8 did not recognize those differences. Implicitly, the dollar was designated the functional currency for all foreign operations. For those operations for which the functional currency was, in fact, the foreign currency, the reported results created by exchange rate changes did not conform with the underlying economic facts and were, therefore, not understood or not credible.

84. Some allege that the functional currency approach does not "result in similar accounting for similar situations." The Board believes a significant virtue of that approach is that it provides different accounting for significantly different economic facts. Because the facts will sometimes give mixed signals, and because management's judgment will be required to identify, weigh, and interpret the facts within the objectives and guidance in this Statement, the Board acknowledges the possibility that, occasionally, situations that appear similar may be accounted for in different ways. That is always a risk when standards must be applied with judgment. The Board believes that risk is likely to do less damage to the usefulness of financial reporting than arbitrary rules that overlook economic differences and require different situations to be accounted for as though

they were the same.

Consolidation of Foreign Currency Statements

85. Critics of the functional currency approach assert that it is not consistent with consolidation theory and that it violates the single entity and "single unit of measure" concepts that they believe underlie consolidated financial statements. The Board believes that, for an enterprise operating in multiple currency environments, a true "single unit of measure" does not, as a factual matter, exist.

86. As noted elsewhere, multiple units of currency are an economic fact of foreign operations, and a translation method cannot prevent the effects of multiple units from showing up in financial statements. The temporal method obscures the fact of multiple units by requiring all transactions to be measured as if the transactions occurred in dollars. As a result, it produces profit margins and earnings fluctuations that do not synchronize with the economic events that affect an entity's operations. All translation methods, including both the temporal and current rate methods, involve multiple currency units at the foreign entity level and a single currency unit, the dollar, at the consolidated reporting level. They only differ in how they bridge from multiple units to the single unit.

87. Proponents of a "single unit of measure" would require the historical cost of inventories and property, plant, and equipment acquired by a foreign entity in a foreign currency to be measured in terms of the equivalent number of dollars at the date of acquisition; that is, they would translate the foreign currency acquisition cost using the historical exchange rate. Statement 8 is based on that proposition. At the same time, however, many of those same proponents recommend that present standards (that is, Statement 8) be improved by requiring the foreign currency acquisition cost of inventories to be translated using the current exchange rate. Whether that proposal is presented as a departure from their perception of generally accepted accounting principles that require inventories to be measured at historical cost or as a departure from their perception of a "single unit of measure" is not always clear. Whatever the nature of the exception, some of those recommending it would have it apply to all inventories acquired by a foreign entity, others only to inventories for which the last-in, first-out method is not used, others only for inventory acquired locally, and still others to various combinations of those possibilities. No matter how the proposal might be applied, it would be impossible to adopt it and retain both the "single unit of measure" and accounting for inventories at historical cost.

88. Statement 8 is frequently described as a faithful application of the "single unit of measure" and the historical cost principle. Most agree that the faithful application of the "single unit of measure" and the historical cost principle produces results that are not compatible with the expected economic effects of changes in exchange rates. The Board concluded that for many foreign entities, adhering to a "single unit of measure" was artificial and illusory.

89. The Board also considered the assertion made by some that the functional currency approach is inconsistent with the presentation of consolidated financial statements that include the individual financial statement elements (that is, assets, liabilities, revenues, expenses, gains, losses, etc.) of foreign entities. That assertion seems to be based on the notion that, because the functional currency approach generally considers the relevant economic effect of exchange rate changes to be on the net investment in a foreign entity rather than on certain of its individual financial statement elements, including in consolidated financial statements the individual elements that underlie that net investment is inappropriate. The Board believes that assertion is without merit.

90. As stated in paragraph 1 of ARB No. 51, *Consolidated Financial Statements*:

The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

91. The Board agrees with the presumption in ARB 51 that presenting in consolidated financial statements the individual assets, liabilities, revenues, expenses, and other elements that underlie a net investment in a foreign entity in which there is a controlling financial interest is indeed more meaningful than merely presenting the net investment as a single item, as in the parent company's separate financial statements. Nothing in the functional currency approach suggests that the various entities that are included in consolidated financial statements are not components of a single enterprise. The same individual financial statement elements are aggregated in consolidated financial statements using the functional currency approach as under the temporal method or any of the other methods found in practice prior to Statement 8. Measures of some of the elements presented in consolidated financial statements differ depending on the approach to translation, but the component entities and elements of the consolidated enterprise are the same.

92. Some have also suggested that adoption of the functional currency approach causes reporting currency measures of items presented in consolidated financial statements to depart from the historical cost model found in present practice. The Board has concluded that is not the case. Costs are incurred and exchange transactions take place in the functional currency; the functional currency approach preserves those historical costs and exchange prices. If the functional currency and reporting currency are different, translation of functional currency historical costs and exchange prices into their current dollar equivalent is essential to the process of consolidation, but the exchange rate changes affect the dollar equivalents of those historical costs and exchange prices, not the historical costs and exchange prices actually experienced by

the foreign entity. As explained elsewhere, the Board concluded that the most relevant information about the performance and financial position of foreign entities is provided by the functional currency financial statements of those entities. Using the current exchange rate to restate those functional currency financial statements in terms of their current dollar equivalents preserves that most relevant information.

93. Those who believe that the functional currency approach is inconsistent with consolidation principles sometimes put the argument in terms of a U.S. perspective versus a local perspective. They contend that the local perspective incorrectly assumes that U.S. investors and creditors are interested in functional currency cash flows rather than in dollar cash flows. To the contrary, the Board has adopted the functional currency approach because it believes that approach provides the best basis for assessing an enterprise's dollar cash flows. The foreign entity's net cash flows are one source of dollar cash flows. However, it is only after a foreign entity has realized net cash flows in its functional currency that those cash flows can be converted to dollars. For example, the property, plant, and equipment of a foreign entity is used directly to produce functional currency revenues, and it is only indirectly through the entire earnings process of the foreign entity that the net functional currency cash flows become available for conversion into dollar cash flows.

Translation of Foreign Currency Statements

94. Fundamental to the functional currency approach to translation is the view that, generally, a U.S. enterprise is exposed to exchange risk to the extent of its net investment in a foreign operation. This view derives from a broad concept of economic hedging. An asset, such as plant and equipment, that produces revenues in the functional currency of an entity can be an effective hedge of debt that requires payments in that currency. Therefore, functional currency assets and liabilities hedge one another, and only the net assets are exposed to exchange risk.

95. If all of a foreign entity's assets and liabilities are measured in its functional currency and are translated at the current exchange rate, the net accounting effect of a change in the exchange rate is the effect on the net assets of the entity. That accounting result is compatible with the broad concept of economic hedging on which the net investment view is based. No gains or losses arise from hedged assets and liabilities and the dollar equivalent of the unhedged net investment increases or decreases when the functional currency strengthens or weakens.

96. If a foreign entity transacts business in a currency other than its functional currency, it is exposed to exchange risk on assets and liabilities denominated in those currencies. That risk will be reflected through gains and losses in the functional currency. Those gains and losses affect the foreign entity's functional currency net cash flows that may be reinvested by it or converted and distributed to the parent. That is equally the case for transactions of the foreign entity denominated in the reporting currency.

97. Another aspect of the functional currency approach pertains to the financial results and

relationships of a foreign entity. The functional currency approach views the parent company as having an investment in a foreign business whose foreign currency earnings are generated in its local economic, legal, and political environment and accrue to the benefit of the parent company in the amount of the dollar equivalent of those earnings. That concept views the accounts of the foreign business measured in its functional currency in accordance with U.S. generally accepted accounting principles as the best available indicators of its performance and financial condition.

98. A foreign entity's assets, liabilities, and operations exist in the economic environment of its functional currency. Its costs are incurred in its functional currency and its revenues are produced in its functional currency. Use of a current exchange rate retains those historical costs and other measurements but restates them in terms of the reporting currency, thereby preserving the relationships established in the entity's economic environment. Accordingly, use of the current exchange rate reflects in the consolidated financial statements the inherent relationships appearing in the functional currency financial statements. If a foreign entity is producing net income in its functional currency, the dollar equivalent of that net income will be reflected in the consolidated financial statements. If different exchange rates are used for monetary and nonmonetary items, as in Statement 8, the translated dollar results inevitably differ from the entity's functional currency results. At an extreme, if different rates are used for monetary and nonmonetary items, the results of operations for a foreign entity that, in fact, is operating profitably and is generating functional currency net cash flows may be converted to a loss merely as a result of the mechanical translation process. The Board believes that by preserving the actual indicators of performance and financial condition of each component entity, the consolidated financial statements will portray the best information about the enterprise as a whole.

99. Paragraph 12 of this Statement requires that a foreign entity's revenues, expenses, gains, and losses be translated in a manner that produces amounts approximately as if the underlying elements had been translated on the dates they were recognized (sometimes referred to as the weighted average exchange rate). This 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). The objectives of the functional currency approach, particularly as expressed in paragraph 70(c), might be best served by application of a single current rate, such as the rate at the end of the period, to those elements. This would, however, require restating prior interim periods or recording a catch-up adjustment in income if rates change. The Board therefore rejected this alternative on practical grounds.

100. Translation of the statement of changes in financial position was the subject of frequent comment on both Exposure Drafts on foreign currency translation. APB Opinion No. 19, *Reporting Changes in Financial Position*, permits some flexibility and judgment to meet the stated objectives of a statement of changes and the Board does not intend to change that either by prescribing the form and content of the statement of changes or by requiring a separate

compilation of complete information for each foreign operation. However, Opinion 19 does require disclosure of all important changes in financial position regardless of whether cash or working capital is directly affected and that requirement is not changed in any way by this Statement.

101. The functional currency approach applies equally to translation of financial statements of foreign investees whether accounted for by the equity method or consolidated. It also applies to translation after a business combination. Therefore, the foreign statements and the foreign currency transactions of an investee that are accounted for by the equity method should be translated in conformity with the requirements of this Statement in applying the equity method. Likewise, after a business combination accounted for by the purchase method, the amount allocated at the date of acquisition to the assets acquired and the liabilities assumed (including *goodwill* or *an excess of acquired net assets over cost* as those terms are used in APB Opinion No. 16, *Business Combinations*) should be translated in conformity with the requirements of this Statement. Accumulated translation adjustments attributable to minority interests should be allocated to and reported as part of the minority interest in the consolidated enterprise.

Translation of Operations in Highly Inflationary Economies

102. Translation of operations in highly inflationary economies is frequently cited as a problem if all assets and liabilities are translated using current exchange rates. In the historical cost model, a reasonably stable measuring unit is an essential ingredient to useful reporting of financial position and operating results over periods of time. Any degree of inflation affects the usefulness of information measured in nominal currency units. If historical costs are measured in nominal currency units in a highly inflationary environment, those measures of historical cost rapidly lose relevance.

103. Because it is a common condition, users of financial statements have developed tolerance for some inflation and in varying degrees compensate for it in their analyses. As inflation increases or persists, however, nominal currency units of the inflationary environment are not useful measures of performance or investment, and a more stable unit of measure must be found.

104. The point at which a substitute measuring unit is necessary is a subjective one. It depends on a number of factors, including the current and cumulative rates of inflation and the capital intensiveness of the operation. In principle, however, a more stable measuring unit is always preferable to a less stable one.

105. The Board has considered a number of alternative methods for restating to a more stable measuring unit. None of the methods is completely satisfactory at this time, either because they are deemed to be incompatible with the functional currency concept or because they involve some aspect of accounting for the effects of inflation in the basic financial statements. Statement 33 calls for experimentation with reporting the effects of inflation on a supplemental basis, not in the basic financial statements. Accordingly, in the 1980 Exposure Draft, the Board proposed not

to specify special translation provisions for reporting on operations in highly inflationary economies, pending resolution of the issues being tested in supplemental reporting on the effects of inflation.

106. Virtually every respondent to the 1980 Exposure Draft who addressed translation of operations in highly inflationary economies pointed out that, unless special provisions are made, the proposed translation method could report misleading results. Accordingly, in the revised Exposure Draft, the Board proposed that the financial statements of a foreign entity with a functional currency of a country that has a highly inflationary economy be restated to reflect changes in the general price level in that country prior to translation. Many respondents objected to the revision, generally on one or more of the following grounds:

- a. Information restated to reflect changes in the general price level should not be required in the primary financial statements until and unless the usefulness of that information has been adequately demonstrated in the Statement 33 experiment.
- b. The primary financial statements should not mix information presented in constant measuring units that reflect changes in the general price level with information presented in nominal monetary units.
- c. The lack of reliable and timely price-level indexes in some highly inflationary economies constitutes a significant obstacle to practical application of the proposal.

107. In view of the difficulties with the proposal, the Board decided that the practical alternative, recommended by many respondents, is to require that the financial statements of foreign entities in those economies that meet the definition of highly inflationary be remeasured as if the functional currency were the reporting currency. This is essentially a pragmatic decision. The Board nonetheless believes that a currency that has largely lost its utility as a store of value cannot be a functional measuring unit. If the reporting currency is more stable, it can be used as the functional currency without introducing a form of inflation accounting.

108. The revised Exposure Draft also allowed latitude for restatement of operations in economies that are less than highly inflationary. Many respondents believed that this flexibility would significantly reduce the consistency and comparability of reporting among companies. The Board agreed and removed the latitude in the final Statement.

109. The definition of a highly inflationary economy as one that has cumulative inflation of *approximately* 100 percent or more over a 3-year period is necessarily an arbitrary decision. In some instances, the trend of inflation might be as important as the absolute rate. It is the Board's intention that the definition of a highly inflationary economy be applied with judgment.

Translation Adjustments

110. Translation adjustments arise from either consolidation or equity method accounting for a net investment in another entity having a different functional currency from that of the investor.

111. Translation adjustments do not exist in terms of functional currency cash flows. Translation adjustments are solely a result of the translation process and have no direct effect on reporting currency cash flows. Exchange rate changes have an indirect effect on the net investment that may be realized upon sale or liquidation, but that effect is related to the net investment and not to the operations of the investee. Prior to sale or liquidation, that effect is so uncertain and remote as to require that translation adjustments arising currently should not be reported as part of operating results.

112. Assenting Board members hold two views of the nature of translation adjustments. Since both views exclude these adjustments from net income and include them in equity, the Board did not consider it necessary to settle on which view should be accepted.

113. The first view is described in terms of a parent (investor) with the dollar as the reporting and functional currency and an investment position in another entity with a functional currency other than the dollar. A change in the exchange rate between the dollar and the other currency produces a change in the dollar equivalent of the net investment although there is no change in the net assets of the other entity measured in its functional currency. A favorable exchange rate change enhances the dollar equivalent; an unfavorable exchange rate change reduces the dollar equivalent. Accordingly, the translation adjustment reflects an economic effect of exchange rate changes. However, that change in the dollar equivalent of the net investment is an unrealized enhancement or reduction, having no effect on the functional currency net cash flows generated by the foreign entity which may be currently reinvested or distributed to the parent. For that reason, the translation adjustment is reported separately from the determination of net income. That adjustment is accumulated separately as part of equity. Concepts Statement 3 defines *comprehensive income* as the change in equity (net assets) of an entity during a period from transactions from nonowner sources. The first view considers the translation adjustment to be an unrealized component of comprehensive income that, for the reasons given above, should be reported separately from net income.

114. The second view regards the translation adjustment as merely a mechanical by-product of the translation process, a process that is essential to providing aggregated information about a consolidated enterprise. An analogy may be drawn between the cumulative foreign currency translation adjustment and the difference between equity (net assets) measured in constant dollars and the same net assets measured in nominal dollars. Viewed as such, the translation adjustment for a period should be excluded from the determination of net income, reported separately, and included as a separate component of equity. In this respect, it represents a restatement of previously reported equity similar to that developed in constant dollar accounting to restate equity in constant dollars from an earlier date to a current date after a change in the constant dollar unit of measure has occurred. Concepts Statement 3, in paragraph 58, anticipated that such restatements would be made to equity without being included in current-period comprehensive income.

115. Both views of the nature of translation adjustments report the same measure of net income and the same information about equity. The Board believes its requirements for disposition and disclosure of translation adjustments are consistent with both views.

116. The Board considered whether at some time the separately reported component of equity should be included in net income. Under the first view, the adjustments have already been included in comprehensive income and should not be included again. Any elimination of the separate component of equity should be accomplished by combining the different classes of items in equity. Under the second view, the translation adjustments are a direct restatement of equity, a form of capital adjustment. It would be contrary to that view to include them in income at any time.

117. Some respondents suggested that the translation adjustments be amortized to income over the lives or maturities of the individual assets and liabilities of the investee, or some relatively long arbitrary period. The Board did not adopt that approach because, as previously stated, translation adjustments are unrealized and do not have the characteristics of items generally included in determining net income.

118. The 1980 Exposure Draft called for recognition of translation adjustments in determining net income based upon permanent impairment of a net investment. That proposal was reconsidered and rejected. The Board concluded that any required provisions for asset-impairment adjustments should be made prior to translation and consolidation.

119. Pending completion of its project on reporting comprehensive income, however, the Board decided to include the accumulated translation adjustments in net income as part of the net gain or loss from sale or complete or substantially complete liquidation of the related investment. Sale and complete or substantially complete liquidation were selected because those events generally cause a related gain or loss on the net investment to be recognized in net income at that time. That procedure recognizes the "unrealized" translation adjustment as a component of net income when it becomes "realized." Although the information is probably marginal, the Board believes that this disposition is desirable until the concepts of reporting all components of comprehensive income are further developed. This disposition also can be considered to be in line with the existing view that nonowner transactions or events that change equity should be recognized in net income at some point.

Transaction Gains and Losses

120. A foreign currency transaction is a transaction that is denominated (requires settlement) in a currency other than the functional currency of an entity. Foreign currency transactions typically result from the import or export of goods, services, or capital. Examples include a sale denominated in Swiss francs, a Swiss franc loan, and the holding of Swiss francs by an entity whose functional currency is the dollar. Likewise, a Swiss franc denominated transaction by a German entity or other entity whose functional currency is not the Swiss franc is a foreign

currency transaction. For any entity whose functional currency is not the dollar, a dollar-denominated transaction is also a foreign currency transaction.

121. The Board has concluded that gains and losses from foreign currency transactions have a different economic nature and therefore require different accounting treatment from that applied to adjustments arising from translating the financial statements of foreign entities from their functional currencies into the reporting currency for the purposes of consolidation. Accordingly, the accounting requirements for disposing of transaction gains and losses and translation adjustments are different.

122. Transaction gains or losses arise when monetary assets and liabilities (cash, receivables, and payables) are denominated in a currency other than the functional currency and the exchange rate between those currencies changes. They can arise at either or both the parent and the subsidiary entity level.

123. Transaction gains and losses have direct cash flow effects when foreign-denominated monetary assets or liabilities are settled in amounts greater or less than the functional currency equivalent of the original transactions.

124. The Board has concluded that such gains or losses should be reflected in income when the exchange rates change rather than when the transaction is settled or at some other intermediate date or period. This is consistent with accrual accounting; it results in reporting the effect of a rate change that will have cash flow effects when the event causing the effect takes place.

125. Some have proposed that a transaction gain or loss should be deferred if the rate change that caused it might be reversed before the transaction is settled. The argument is that to recognize transaction gains and losses from rate changes in determining net income creates needless fluctuations in reported income if those transaction gains and losses might be canceled by future reversals of rate changes. The Board rejected the proposal on both conceptual and practical grounds. Past rate changes are historical facts, and the Board believes that users of financial statements are best served by accounting for rate changes that affect the functional currency cash flows of a foreign entity as those rate changes occur. The proposal is also impractical; future changes, including reversals, cannot be reliably predicted. As a result, a transaction gain or loss might ultimately have to be recognized during a period in which rate changes are unrelated to the recognized gain or loss.

126. The Board saw no conceptual basis for an alternative proposal for recognition of transaction gains or losses when unsettled balances are classified as current assets and liabilities (or as they became due within one year). Such a requirement would place emphasis on the balance sheet classification or settlement date rather than on the economic effect of the exchange rate movement. It would also add a further accounting complexity without a compensating benefit.

127. Others have proposed that transaction gains and losses, particularly those related to long-term debt, should be deferred and amortized over the life of the related liabilities as part of the costs of borrowing. The Board agrees that transaction gains and losses on amounts borrowed in a different currency might be considered part of the cost of the borrowed funds. However, no rational procedure can be prescribed to accrue the total cost at an average effective rate because until the liability is settled that average rate cannot be objectively determined. Amortization of the effect of past exchange rate changes over the remaining life of the borrowing does not accomplish that result. It changes the pattern of gain or loss recognition in net income, but it may retain much of the volatility that advocates seek to eliminate. Further, amortization allocates the effect of an exchange rate change to periods not related in any way to changes in rates or other economic events affecting the enterprise.

Foreign Currency Transactions That Hedge a Net Investment

128. Paragraph 20(a) of this Statement provides that transaction gains and losses attributable to a foreign currency transaction that is designated as, and is effective as, an economic hedge of a net investment in a foreign entity shall be reported in the same manner as translation adjustments and that such accounting shall commence as of the designation date. If a foreign currency transaction is in fact an economic hedge of a net investment, then the accounting for the effect of a rate change on the transaction should be the same as the accounting for the effect of the rate change on the net investment, that is, both of those partially or fully offsetting amounts should be included in the separate component of equity.

129. An example of the situation contemplated in paragraph 20(a) would be a U.S. parent company with a net investment in a subsidiary that is located in Switzerland and for which the Swiss franc is the functional currency. The U.S. parent might also borrow Swiss francs and designate the Swiss franc loan as a hedge of the net investment in the Swiss subsidiary. The loan is denominated in Swiss francs which are not the functional currency of the U.S. parent and, therefore, the loan is a foreign currency transaction. The loan is a liability, and the net investment in the Swiss subsidiary is an asset. Subsequent to a change in exchange rates, the adjustment resulting from translation of the Swiss subsidiary's balance sheet would go in the opposite direction from the adjustment resulting from translation of the U.S. parent company's Swiss franc debt. To the extent that the adjustment from translation of the Swiss franc loan (after tax effects, if any) is less than or equal to the adjustment from translation of the Swiss subsidiary's balance sheet, both adjustments should be included in the analysis of changes in the cumulative translation adjustment and reflected in the separate component of equity. However, any portion of the adjustment from translation of the U.S. parent company's Swiss franc debt (after tax effects, if any) that exceeds the adjustment from translation of the Swiss subsidiary's balance sheet is a transaction gain or loss that should be included in the determination of net income.

130. Ordinarily, a transaction that hedges a net investment should be denominated in the same currency as the functional currency of the net investment hedged. In some instances, it may not

be practical or feasible to hedge in the same currency and, therefore, a hedging transaction also may be denominated in a currency for which the exchange rate generally moves in tandem with the exchange rate for the functional currency of the net investment hedged.

Transaction Gains and Losses Attributable to Intercompany Transactions

131. Paragraph 20(b) of this Statement addresses transaction gains and losses attributable to intercompany foreign currency transactions that are of a long-term investment nature. 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. Accordingly, related gains or losses are to be reported and accumulated in the same manner as translation adjustments when financial statements for those entities are consolidated, combined, or accounted for by the equity method. Transaction gains and losses attributable to other intercompany transactions and balances, however, affect functional currency cash flows; and increases or decreases in actual and expected functional currency cash flows should be included in determining net income for the period in which exchange rates change.

Foreign Currency Transactions That Hedge Foreign Currency Commitments

132. In response to the Board's invitation for public comment on Statements 1-12, most of the comments received that addressed accounting for forward exchange contracts requested that the Board reconsider the requirement that a forward contract must extend from the foreign currency commitment date to the anticipated transaction date or a later date if the forward contract is to be accounted for as a hedge of a foreign currency commitment. Other commentators have requested that transactions other than forward exchange contracts (for example, a cash balance) also should be accounted for as a hedge of a commitment.

133. The Board believes that if a foreign currency commitment is hedged by a forward contract or by any other type of foreign currency transaction, the accounting for the foreign currency transaction should reflect the economic hedge of the foreign currency commitment. The existence of an economic hedge is a question of fact, not of form. Therefore, the Board did not require any linkage of the date of the hedging transaction with the date of the hedged commitment. However, the foreign currency transaction must be designated as, and effective as, a hedge of a foreign currency commitment. In some instances, it may not be practical or feasible to hedge in the same currency and, therefore, a hedging transaction also may be denominated in a currency for which the exchange rate generally moves in tandem with the exchange rate for the currency in which the hedged commitment is denominated.

Income Tax Consequences of Rate Changes

134. The Board has concluded that interperiod tax allocation is required if transaction gains and

losses from foreign currency transactions are included in income in a different period for financial statement purposes than for tax purposes. This is consistent with the requirements of Opinion 11.

135. The Board also has considered the possible need to provide deferred taxes related to translation adjustments resulting from translation of functional currency statements. Translation adjustments are accumulated and reported in a separate component of equity. Reported as such, translation adjustments do not affect pretax accounting income and most such adjustments also do not affect taxable income. Adjustments that do not affect either accounting income or taxable income do not create timing differences as defined by Opinion 11. However, reporting those adjustments as a component of equity does have the effect of increasing or decreasing equity, that is, increasing or decreasing an enterprise's net assets. Potential future tax effects related to those adjustments would partially offset the increase or decrease in net assets. Therefore, the Board decided that timing differences relating to translation adjustments should be accounted for in the same way as timing differences relating to accounting income. The need for and the amount of deferred taxes should be determined according to the other requirements of Opinions 11, 23, and 24. For example, paragraph 23 of this Statement provides that deferred taxes should not be provided for translation adjustments attributable to an investment in a foreign entity for which deferred taxes are not provided on unremitted earnings. Similarly, Opinions 11, 23, and 24 provide guidance as to how to compute the amount of deferred taxes. Deferred taxes on translation adjustments should be computed in the same manner.

Elimination of Intercompany Profits

136. An intercompany sale or transfer of inventory, machinery, etc., frequently produces an intercompany profit for the selling entity and, likewise, the acquiring entity's cost of the inventory, machinery, etc., includes a component of intercompany profit. The Board considered whether computation of the amount of intercompany profit to be eliminated should be based on exchange rates in effect on the date of the intercompany sale or transfer, or whether that computation should be based on exchange rates as of the date the asset (inventory, machinery, etc.) or the related expense (cost of sales, depreciation, etc.) is translated.

137. The Board decided that any intercompany profit occurs on the date of sale or transfer and that exchange rates in effect on that date or reasonable approximations thereof should be used to compute the amount of any intercompany profit to be eliminated. The effect of subsequent changes in exchange rates on the transferred asset or the related expense is viewed as being the result of changes in exchange rates rather than being attributable to intercompany profit.

Exchange Rates

138. The Board has concluded that if multiple rates exist, the rate to be used to translate foreign statements should be, in the absence of unusual circumstances, the rate applicable to dividend remittances. Use of that rate is more meaningful than any other rate because cash flows to the

reporting enterprise from the foreign entity can be converted at only that rate, and realization of a net investment in a foreign entity will ultimately be in the form of cash flows from that entity.

139. If a foreign entity's financial statements are as of a date that is different from that of the enterprise and they are combined, consolidated, or accounted for by the equity method in the financial statements of the enterprise, the Board concluded that for purposes of applying the requirements of this Statement, the current rate is the rate in effect at the entity's balance sheet date. The Board believes that use of that rate most faithfully presents the dollar equivalent of the functional currency performance during the entity's fiscal period and position at the end of that period. Paragraph 4 of ARB 51 and paragraph 19(g) of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, address consolidation and application of the equity method when a parent and a subsidiary have different fiscal periods. The Board believes its conclusion is consistent with those pronouncements.

Use of Averages or Other Methods of Approximation

140. Paragraph 12 permits the use of average rates to translate revenues, expenses, gains, and losses. Average rates used should 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.

Disclosure

141. Paragraph 30 requires disclosure of the aggregate transaction gain or loss included in the determination of net income for the period. A transaction gain or loss does not measure, nor is it necessarily an indicator of, the full economic effect of a rate change on an enterprise. However, the Board believes that disclosing the aggregate transaction gain or loss may provide information about the effects of rate changes that is useful in evaluating and comparing reported results of operations.

142. Paragraph 31 requires an analysis of the separate component of equity in which translation adjustments, certain transaction gains and losses, and related tax effects are accumulated and reported. Generally accepted accounting principles presently require an analysis of changes in all equity accounts. Nevertheless, the Board has decided that it should specifically require an analysis of the separate component of equity disclosing the major changes in each period for which financial statements are presented. The analysis may be presented in a separate financial statement, in the notes to the financial statements, or as part of the statement of changes in equity. This separate component of equity might be titled "Equity Adjustment from Foreign Currency Translation" or given a similar title.

143. The Board considered whether an enterprise's financial statements should be adjusted for a

change in rate subsequent to the date of the financial statements. The Board concluded that financial statements should not be adjusted for such rate changes. However, disclosure of the rate change and the estimated effect on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary. If disclosed, the disclosure should include consideration of changes in unsettled transactions from the date of the financial statements to the date the rate changed. The Board recognizes that in some cases it may not be practicable to determine these changes; if so, that fact should be stated.

144. The Board considered a proposal for financial statement disclosure that would describe and possibly quantify the effects of rate changes on reported revenue and earnings. This type of disclosure might have included 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. After considering information that it received on this matter, the Board has decided not to require disclosure of this type of information, primarily because of the wide variety of potential effects, the perceived difficulties of developing the information, and the impracticality of providing meaningful guidelines. However, the Board encourages management to supplement the disclosures required by this Statement with an analysis and discussion of the effects of rate changes on the reported results of operations. 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.

Effective Date and Transition

145. The Board considered and rejected both a completely prospective and a completely retroactive application of the accounting standards required by this Statement.

146. A completely prospective application was rejected because continued translation of previously acquired nonmonetary assets and related expenses at historical rates is inconsistent with the Board's other decisions regarding foreign currency translation. Regarding retroactive application, there are two possible effects resulting from the change to the accounting requirements of this Statement. Those effects are:

- a. An increase or decrease in the enterprise's net assets resulting from translating all of a foreign entity's assets and liabilities at the current exchange rate for that entity's functional currency.
- b. A reclassification between retained earnings and the new separate component of equity for cumulative translation adjustments so that retained earnings would equal an amount as if, since inception, translation adjustments had not been recognized in income and as if expenses related to nonmonetary items had not been translated at historical rates. (Such a reclassification between retained earnings and cumulative translation adjustments would have no effect on an enterprise's net assets or the total amount of equity.)

The Board has decided that the effect on net assets (first possible effect listed above) should be reported as the opening balance of the separate component of equity for cumulative translation adjustments as of the beginning of the year for which this Statement is first applied. Reclassification of amounts between retained earnings and the separate component of equity (second possible effect listed above) would require recomputation of amounts for all prior years for which an enterprise had foreign investments. The Board has decided that the benefits of such a recomputation, even if possible, would not justify the cost and should not be required.

147. The Board recognizes that Statement 8 accounting exposure has been hedged by the management of some enterprises and that different management actions might have been taken if Statement 8 had not been in effect. Therefore, restatement of financial statements presented for fiscal years prior to the effective date of this Statement is not required. However, restatement is permitted and, if the prior fiscal year is not restated, disclosure of income before extraordinary items and net income for the prior year computed on a pro forma basis is permitted. If pro forma amounts are disclosed, such pro forma amounts should be computed in accordance with Opinion 20.

148. The Board's decision that this Statement should be effective for fiscal years beginning on or after December 15, 1982 is based on the belief that such an effective date will provide sufficient time for enterprises (a) to make any desired changes in financial policies that might be prompted by this Statement and (b) to prepare internally for the accounting requirements of this Statement. Enterprises that want to adopt the provisions of this Statement at an earlier date, however, are encouraged to do so. If adopted for a fiscal year ending on or before March 31, 1982, disclosure of the effect of adopting the new standard is required to provide comparability between those enterprises that do adopt and those that do not adopt the standard before the effective date. This disclosure is not required for fiscal years ending after March 31, 1982 because many enterprises will have terminated some or all hedges of the previous Statement 8 accounting exposure, thereby rendering any determination of the effect virtually impossible. Furthermore, the cost of requiring two systems of translation beyond early 1982 is not justified.

149. The Board is considering an amendment of Statement 33 to provide information that is compatible with the functional currency approach to foreign currency translation. The Board believes that the transition provisions of this Statement provide appropriate flexibility to accommodate any amendment of Statement 33.

Appendix D: BACKGROUND INFORMATION

150. The extensive currency realignments and the major revisions of the international monetary system in the early 1970s, together with the existence in practice of several significantly different methods of accounting for the translation of foreign currency transactions and financial statements, highlighted the need to address foreign currency translation at that time. Statement

8, which was issued in October 1975 and was effective for fiscal years that began on or after January 1, 1976, established standards of financial accounting and reporting for foreign currency translation and eliminated the use of alternative methods.

151. Responding to a recommendation by the Structure Committee of the Financial Accounting Foundation that it experiment with a more formal postenactment review process, the Board issued in May 1978 an invitation for public comment on FASB Statements 1-12, each of which had been in effect for at least two years. More than 200 letters were received, and Statement 8 was the subject of most of the comments received.

152. Respondents were nearly unanimous in their call for changes to Statement 8 but had conflicting views as to what those changes should be. Changes were suggested both in the method to be used in translating financial statements and in the method of disposition of the resulting translation adjustments and transaction gains and losses from foreign currency transactions. Most respondents who suggested changes in the translation method also suggested changes in the method of recognition of the resulting translation effects.

153. Respondents' concerns with Statement 8 reflect the perception that the results of translation under that Statement frequently do not reflect the underlying economic reality of foreign operations. The perceived failure of accounting results to portray the underlying economic circumstances is underscored heavily in two respects: (a) the volatility of reported earnings and (b) the abnormality of financial results and relationships. The sources of both problems are attributed to the requirements for (a) current recognition of unrealized exchange adjustments and (b) that inventories and fixed assets are translated at historical rates under Statement 8, whereas debt is translated at current rates.

154. Many respondents believe that the exchange risk exposure on foreign currency debt is effectively hedged in many cases by the foreign currency revenue potential of operating assets, but that this hedge is not recognized in the Statement 8 translation process. One result is large and frequent fluctuations in reported earnings, which many believe misrepresent the real performance of a company and obscure operating trends. Another result is said to be erratic operating margins and irregular financial relationships that make operating performance difficult to interpret.

155. Recommendations regarding changes in the method of translation of foreign currency statements were that some or all nonmonetary assets (primarily inventories and, less frequently, fixed assets) should be translated at current exchange rates or that long-term debt should be translated at historical rates.

156. The most frequently made recommendations regarding changes to Statement 8 were for some form of deferral or nonrecognition of the exchange adjustments that result from its application. Some respondents stated that exchange rates are affected by rumor, politics, speculation, and other factors so that foreign currency exchange rates at any particular moment

in time are temporary, and that changes over a relatively short time span are not likely to have a long-term effect on a company's earnings or financial position. Those respondents believe that exchange adjustments resulting from transitory rate changes are subject to misinterpretation because short-term rate fluctuations are poor indicators of long-term trends. Moreover, many of those respondents indicated that exchange adjustments from translation of foreign currency statements have not been realized and often will never be realized in amounts approximating the amounts reported in financial statements as required by Statement 8.

157. In January 1979, after considering the FASB staff's analysis of the comment letters, the Board added to its agenda a project to reconsider Statement 8. In February 1979, a task force was appointed to advise the Board during its deliberations on this project. The task force is composed of 22 members and observers from academe, the financial community, government, industry, and public accounting, as well as representatives from the International Accounting Standards Committee, the Accounting Standards Committee of the United Kingdom and Ireland, and the Canadian Institute of Chartered Accountants.

158. Subsequently, foreign currency translation was addressed at 18 public Board meetings and at 4 public task force meetings. In August 1980, the Board issued an Exposure Draft that set forth new proposals for foreign currency translation.

159. The Exposure Draft had a 3-month comment period, and more than 360 comment letters were received. The Board conducted a public hearing on the Exposure Draft in December 1980, and 47 organizations and individuals presented their views at the 4-day hearing.

160. Between January and June 1981, foreign currency translation was addressed at four additional public Board meetings and one public task force meeting. The Board's consideration of the issues resulted in modifications that the Board believed were significant in the aggregate. Accordingly, a revised Exposure Draft was issued on June 30, 1981.

161. The revised Exposure Draft had a 90-day comment period, and more than 260 comment letters were received. In October and November 1981, foreign currency translation was addressed at two additional public Board meetings and one public task force meeting. Consideration of the written comments resulted in further modifications as reflected in this Statement.

Appendix E: GLOSSARY

162. This appendix defines terms that are essential to clear comprehension of this Statement. They are set in **boldface type** the first time they appear in this Statement.

Attribute

The quantifiable characteristic of an item that is measured for accounting purposes. For example, historical cost and current cost are attributes of an asset.

Conversion

The exchange of one currency for another.

Currency Swaps

An exchange between two enterprises of the currencies of two different countries pursuant to an agreement to reexchange the two currencies at the same rate of exchange at a specified future date.

Current Exchange Rate

The current exchange rate is the rate at which one unit of a currency can be exchanged for (converted into) another currency. For purposes of translation of financial statements referred to in this Statement, the current exchange rate is the rate as of the end of the period covered by the financial statements or as of the dates of recognition in those statements in the case of revenues, expenses, gains, and losses. The requirements for applying the current exchange rate for translating financial statements are set forth in paragraph 12. Further information regarding exchange rates is provided in paragraphs 26-28.

Discount or Premium on a Forward Contract

The foreign currency amount of the contract multiplied by the difference between the contracted forward rate and the spot rate at the date of inception of the contract.

Enterprise

See Reporting Enterprise.

Entity

See Foreign Entity.

Foreign Currency

A currency other than the functional currency of the entity being referred to (for example, the dollar could be a foreign currency for a foreign entity). Composites of currencies,

such as the Special Drawing Rights on the International Monetary Fund (SDRs), used to set prices or denominate amounts of loans, etc., have the characteristics of foreign currency for purposes of applying this Statement.

Foreign Currency Statements

Financial statements that employ as the unit of measure a functional currency that is not the reporting currency of the enterprise.

Foreign Currency Transactions

Transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions arise when an enterprise (a) buys or sells on credit goods or services whose prices are denominated in foreign currency, (b) borrows or lends funds and the amounts payable or receivable are denominated in foreign currency, (c) is a party to an unperformed forward exchange contract, or (d) for other reasons, acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currency.

Foreign Currency Translation

The process of expressing in the reporting currency of the enterprise those amounts that are denominated or measured in a different currency.

Foreign Entity

An operation (for example, subsidiary, division, branch, joint venture, etc.) whose financial statements (a) are prepared in a currency other than the reporting currency of the reporting enterprise and (b) are combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting enterprise.

Forward Exchange Contract

An agreement to exchange at a specified future date currencies of different countries at a specified rate (forward rate).

Forward Rate

See Forward Exchange Contract.

Functional Currency

An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. (See Appendix A.)

Local Currency

The currency of a particular country being referred to.

Reporting Currency

The currency in which an enterprise prepares its financial statements.

Reporting Enterprise

An entity or group whose financial statements are being referred to. In this Statement, those financial statements reflect (a) the financial statements of one or more foreign operations by combination, consolidation, or equity accounting; (b) foreign currency transactions; or (c) both of the foregoing.

Spot Rate

The exchange rate for immediate delivery of currencies exchanged.

Transaction Date

The date at which a transaction (for example, a sale or purchase of merchandise or services) is recorded in accounting records in conformity with generally accepted accounting principles. A long-term commitment may have more than one transaction date (for example, the due date of each progress payment under a construction contract is an anticipated transaction date).

Transaction Gain or Loss

Transaction gains or losses result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in (a) the actual functional currency cash flows realized upon settlement of foreign currency transactions and (b) the expected functional currency cash flows on unsettled foreign currency transactions.

Translation

See Foreign Currency Translation.

Translation Adjustments

Translation adjustments result from the process of translating financial statements from the entity's functional currency into the reporting currency.

Unit of Measure

The currency in which assets, liabilities, revenues, expenses, gains, and losses are measured.

Footnotes

FAS52, Footnote 1--Terms defined in the glossary (Appendix E) are in **boldface type** the first time they appear in this Statement.

FAS52, Footnote 1--The following pronouncements, which were superseded or amended by Statement 8, are also superseded or amended by this Statement: paragraphs 7 and 10-22 of Chapter 12, "Foreign Operations and Foreign Exchange," of ARB No. 43; paragraph 18 of APB Opinion No. 6, *Status of Accounting Research Bulletins*; and FASB Statement No. 1, *Disclosure of Foreign Currency Translation Information*. The last sentence of paragraph 5 of ARB 43, Chapter 12, is amended to delete "and they should be reserved against to the extent that their realization in dollars appears to be doubtful," and paragraph 13 of APB Opinion No. 22, *Disclosure of Accounting Policies*, is amended to delete "translation of foreign currencies" as an example of disclosure "commonly required with respect to accounting policies."

FAS52, Footnote 2--For convenience, this Statement assumes that the enterprise uses the U.S. dollar (dollar) as its reporting currency. However, a currency other than the dollar may be the reporting currency in financial statements that are prepared in conformity with U.S. generally accepted accounting principles. For example, a foreign enterprise may report in its **local currency** in conformity with U.S. generally accepted accounting principles. If so, the requirements of this Statement apply.

FAS52, Footnote 3--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. To illustrate: Two foreign branches of a U.S. company, 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 German marks. Although the corresponding liability is also measured in marks, 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.

FAS52, Footnote 4--If unsettled intercompany 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 intercompany receivables and payables. Until that difference is eliminated by settlement of the intercompany transaction, the difference shall be treated as a receivable or payable in the enterprise's financial statements.

FAS52, Appendix B, Footnote *--The guidance in this appendix applies only to those instances in which the books of record are not maintained in the functional currency.

FAS52, Appendix B, Footnote 5--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.

FAS52, Appendix B, Footnote 6--This paragraph is not intended to preclude recognition of gains in a later interim period to the extent of inventory losses recognized from market declines in earlier interim periods if losses on the same inventory are recovered in the same year, as provided by paragraph 14(c) of APB Opinion No. 28, *Interim Financial Reporting*, which states: "Inventory losses from market declines should not be deferred beyond the interim period in which the decline occurs. Recoveries of such losses on the same inventory in later interim periods of the same fiscal year through market price recoveries should be recognized as gains in the later interim period. Such gains should not exceed previously recognized losses. Some market declines at interim dates, however, can reasonably be expected to be restored in the fiscal year. Such *temporary* market declines need not be recognized at the interim date since no loss is expected to be incurred in the fiscal year."

FAS52, Appendix B, Footnote 7--An inventory write-down also may be required for imported inventory.

FAS52, Appendix B, Footnote*--BR= Currency in which the books of record are maintained
FC= Functional currency

FAS52, Appendix B, Footnote 8--Statement 8, paragraphs 50-52.

FAS52, Appendix B, Footnote 9--Interpretation 15, paragraph 4.

FAS52, Appendix C, Footnote 10--FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 43.