Chapter Twelve

Multinational Accounting: Issues in Financial Reporting and Translation of Foreign Entity Statements

McDONALD'S—THE WORLD'S FAST FOOD FAVORITE

McDonald's was founded in 1940 by two brothers, Dick and Mac McDonald, in San Bernardino, California. The McDonald brothers introduced the "Speedee Service System" in 1948, which laid the groundwork for modern fast-food restaurants.

In 1954, the brothers were using four Multimixer milkshake machines in their San Bernardino location. This piqued the interest of Ray Kroc, one of Multimixer's distributors, so he headed to San Bernardino to see "what the devil was going on." Kroc was so impressed with the McDonald brothers' operation that he convinced them to allow him to franchise their restaurants throughout the country. In 1955, Kroc opened his first McDonald's franchise in Des Plaines, Illinois.

The chain grew slowly at first, operating 79 restaurants at the end of 1958. However, in 1959, Kroc expanded aggressively, opening 66 new restaurants. Two years later, he bought out the McDonald brothers' interest for $2.7 million. And just four years later he took the company public. Success continued for McDonald's for the rest of the 1960s. In 1963, the company sold its one billionth hamburger and, in 1968, it introduced the famous Big Mac and opened its 1,000th restaurant.

The 1970s were not much different. By 1971, McDonald's was operating restaurants in all 50 states. The company introduced the Egg McMuffin and the Happy Meal in 1975 and 1979, respectively. The McDonald's drive-thru was introduced in 1975 and in 1976 McDonald's sold its 20 billionth hamburger. The 1980s started out strong with the unveiling of the McChicken in 1983. In 1985, McDonald's became one of the 30 companies composing the Dow Jones Industrial Average.

The 1990s was a time of international growth for McDonald's. In 1992, 66 percent of McDonald's revenue came from U.S. sales. That number dropped to about 43 percent in 1998 and then to about 32 percent in 2011. In 1991, only 3,600 international locations were in operation, but by 1998, that number had more than tripled to 11,000. Clearly, McDonald's has become a symbol of globalization. With locations in virtually every country in the world, McDonald's is the epitome of a multinational corporation. Managing such a widespread

global empire requires a detailed understanding of accounting and the effects of currency changes on the company's financial statements.

Differences in accounting standards across countries and jurisdictions can cause significant difficulties for multinational firms such as McDonald's. In fact, one of the significant challenges McDonald's faces is the preparation of financial statements according to the differing standards in countries where its subsidiaries are located and the subsequent consolidation of these foreign-based financial statements. These and other significant problems that result from differences in accounting standards have generated significant interest in the harmonization of accounting standards globally.

In addition, because of its global presence, McDonald's has to constantly monitor fluctuations in foreign currencies. The following table from McDonald's 2011 Form 10-K shows the effects of translating subsidiaries' financial statements from foreign currencies to U.S. dollars. For example, revenues in 2011 were positively affected by $944 million as a result of foreign currency fluctuations.

	Reported Amount			Currency Translation Benefit/(Cost)		
In millions, except per share data	**2011**	**2010**	**2009**	**2011**	**2010**	**2009**
Revenues	**$27,006**	$24,075	$22,745	**$ 944**	$188	$ (1,340)
Company-operated margins	**3,455**	3,173	2,807	**134**	35	(178)
Franchised margins	**7,232**	6,464	5,985	**213**	(14)	(176)
Selling, general, & administrative expenses	**2,394**	2,333	2,234	**(55)**	(12)	75
Operating income	**8,530**	7,473	6,841	**301**	13	(273)
Net income	**5,503**	4,946	4,551	**195**	13	(164)
Earnings per common share—diluted	**5.27**	4.58	4.11	**0.19**	0.01	(0.15)

Accountants preparing financial statements of global companies must consider (1) differences across national boundaries in accounting principles and (2) differences in currencies used to measure the operations of companies operating in different countries. Translation or restatement into U.S. dollars is necessary before a foreign subsidiary's financial statements can be consolidated with the U.S. parent company's statements, which are already reported in dollars. This chapter summarizes current efforts to develop a global set of high-quality accounting standards and explores the translation of financial statements of a foreign business entity into U.S. dollars.

LEARNING OBJECTIVES

When you finish studying this chapter, you should be able to:

LO 12-1 Understand and explain the benefits and ramifications of convergence to international financial reporting standards (IFRS) and the expected timeline to global convergence.

LO 12-2 Determine the functional currency and understand the ramifications of different functional currency designations.

LO 12-3 Understand and explain the differences between translation and remeasurement.

LO 12-4 Make calculations and translate financial statements of a foreign subsidiary.

LO 12-5 Prepare consolidated financial statements including a foreign subsidiary after translation.

LO 12-6 Make calculations and remeasure financial statements of a foreign subsidiary.

LO 12-7 Prepare consolidated financial statements including a foreign subsidiary after remeasurement.

LO 12-8 Understand other issues related to foreign operations including the hedging of a net investment in a foreign subsidiary.

CONVERGENCE OF ACCOUNTING PRINCIPLES

LO 12-1

Understand and explain the benefits and ramifications of convergence to international financial reporting standards (IFRS) and the expected timeline to global convergence.

Methods used to measure economic activity differ around the world. Many factors influence the development of accounting standards in a country, including its economic, legal, educational, and political systems; its stage of technological development; its culture and traditions; and other socioeconomic factors. These differences have led to significant diversity in accounting standards from one nation to another. The lack of a uniform set of accounting standards creates problems for companies, preparers, and users. Some countries develop their accounting principles based on the information needs of the taxing authorities. Other countries have accounting principles designed to meet the needs of central government economic planners. U.S. accounting standards focus on the information needs of the common stockholder or the creditors.

Arthur Levitt, former chairman of the Securities and Exchange Commission (SEC), noted in 1999 that the world economy was in a period of profound change because the notion of distance as a barrier was no longer a relevant impediment to business growth and development. Levitt noted that the flow of capital is a critical factor in global economic development, which had created a compelling need for a common business-reporting language. Indeed, Levitt stated that "new business opportunities demand financial reporting standards that supersede national borders and cultural customs. These standards are not merely an ideal for a better global marketplace—they are fundamental to its very existence."[1]

During the decade following Levitt's statement, significant strides have been taken to move toward a single set of globally accepted reporting standards. Important benefits can be realized from the adoption of globally consistent accounting standards. Expected benefits include continued expansion of capital markets across national borders. Countries in which accounting principles do not currently focus on the needs of investors could more quickly achieve stable, liquid capital markets, which in turn should drive economic growth. Use of a single set of accounting standards should help investors to better evaluate opportunities across national borders, which also should facilitate a more efficient use of global capital. A set of global standards also should reduce reporting costs that corporations currently incur if they attempt to access capital in markets outside their home country because they will no longer need to produce multiple sets of financial statements using different sets of accounting standards. Financial statement users are likely to have more confidence in financial reporting if it conforms to standards that have gained wide global acceptance.

The major financial reporting model that will very likely become globally accepted is being developed by the International Accounting Standards Board (IASB), an independent, privately funded accounting standards-setting body based in London. The IASB's mission is to develop a single set of high-quality, understandable, and enforceable global accounting standards. Standards published by the IASB are called ***International Financial Reporting Standards (IFRS).*** The IASB is composed of 15 members who serve a five-year term subject to one reappointment. Members are required to sever all employment relationships that might compromise their independent judgment in setting accounting standards. When evaluating potential standards, the IASB solicits input from the public and publishes a discussion paper and/or an exposure draft subject to comment before issuing a final standard. The IASB also has an advisory council, the Standards Advisory Council, that is composed of approximately 40 individuals from diverse countries and draws members from both countries that have and have not adopted IFRS. The IASB has a mandate from the International Organization of Securities Commissions (IOSCO) to develop a high-quality set of international financial reporting standards. This effort has the support of the U.S. regulators and standard setters.

[1] Arthur Levitt, "Remarks to the American Council on Germany: Corporate Governance in a Global Arena," Speech by SEC Chairman, October 7, 1999, http://www.sec.gov/news/speech/speecharchive/1999/spch302.htm.

There is already widespread acceptance of IFRS around the world as these standards are mandated or permitted in more than 100 countries around the world. Beginning in 2005, the European Union (EU) mandated the use of IFRS for companies listing on stock exchanges in the EU, although it continues to accept statements prepared according to U.S. GAAP. According to the SEC, the number of foreign private issuers who file within the United States has increased significantly from a relatively few companies in 2005 to approximately 110 in 2006. These companies prepare financial statements that comply with IFRS as published by the IASB. Furthermore, the Commission expects to see this number continue to increase in the future, particularly because Canada adopted IFRS in 2011; there currently are approximately 500 foreign private issuers from Canada. This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies reports under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries' financial statements according to IFRS for purposes of local regulatory or statutory filings.

The FASB is working with the IASB to improve the quality of reporting standards and to "converge" their two sets of standards. In September 2002, the FASB issued the "Norwalk Agreement" in which both the FASB and the IASB pledged to work together both to improve the quality of their financial reporting standards and to converge the standards by working to minimize the differences between them. The convergence effort focuses on evaluating and implementing existing standards along with developing new ones. PricewaterhouseCoopers offers a publication on its website entitled "IFRS and US GAAP: Similarities and Differences" that provides a topic-based comparison. This publication can be accessed on the Internet at http://www.pwc.com/us/en/issues/ifrs-reporting/publications/ifrs-and-us-gaap-similarities-and-differences.jhtml.

Until 2007, the SEC required foreign issuers that do use U.S. GAAP to reconcile their financial statements to U.S. GAAP and to file this reconciliation with the SEC on a Form 20-F. On January 4, 2008, the SEC issued new rules that allow foreign private issuers to file statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP.[2] Removing the Form 20-F requirement for companies strictly following IFRS reduces costs to foreign private issuers and encourages their continued participation in the U.S. public capital market, which is a benefit to investors by increasing investment possibilities and furthering the efficient allocation of capital. Note, however, that the 20-F reconciliation is still required for companies that do not follow IFRS "as issued by the IASB." Many countries have their own "version" of IFRS in which they adopt most of IFRS as promulgated by the IASB but also require some country-specific exceptions.

In December 2007, the SEC held roundtable discussions with representatives from public companies, audit firms, investor groups, academia, rating agencies, the legal community, and government agencies to obtain feedback on whether public companies in the United States should be permitted or required to file their consolidated financial statements using IFRS as published by the IASB instead of U.S. GAAP. Among this group, there was overwhelming support for the use of a single set of global standards, and the majority of the panelists agreed that IFRS ultimately will be the standard.

In general, panelists at the SEC roundtable felt that U.S. corporations could be more competitive globally if they were permitted to use IFRS for financial reporting. Benefits expected to accrue to U.S. firms include

- Increased quality of information available to investors.
- Reduced costs of compliance for companies that are currently using multiple reporting frameworks.

[2] Securities and Exchange Commission, "Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP," *Federal Register* 73, no. 3 (January 4, 2008), pp. 986–1012, www.sec.gov/rules/final/2008/33-8879fr.pdf.

- Enhanced global capital markets.
- Improved access to capital in the global markets.
- Enhanced comparability across companies for users. Former SEC Chairman Christopher Cox noted that two-thirds of U.S. investors own securities of foreign companies.

Moreover, because the SEC now permits foreign private issuers to file their financial reports using IFRS without reconciliation, not allowing U.S. companies to report under IFRS could result in U.S. companies bearing costs not incurred by foreign private issuers. Some observers fear that U.S. influence in the world economy could decline if more countries move to IFRS but the United States does not. Not only are U.S. investors divesting themselves of U.S. holdings and investing in non-U.S. holdings but also more companies are electing to raise capital on non-U.S. exchanges. As recently as 2000, nine of every 10 dollars raised for foreign companies through new stock offerings were done in New York. However, by 2005, nine of every 10 dollars were raised through new company listings in London or Luxembourg.[3]

Significant issues still must be addressed before a decision about adoption of IFRS by U.S. corporations can be made. Extensive training for professionals, users, and even regulators may be necessary. Still, many believe that convergence to a single set of international standards is key to economic development. Among 143 worldwide leaders of the accounting profession representing 91 countries who responded to a survey conducted by the International Federation of Accountants, 89 percent indicated that convergence to international financial reporting standards was either important or very important for economic growth in their countries, and only 1 percent said it was not important.

Nevertheless, on February 24, 2010, the SEC issued a formal statement supporting convergence to a single set of global accounting standards, directing its staff to prepare a work plan to allow it to decide on a mandate for accepting IFRS for U.S. registrants. This work plan outlines the activities the SEC staff will undertake to provide the SEC information for determining whether, when, and how to incorporate IFRS into the reporting system in the United States. This work plan addresses six concerns from comments received on the SEC's IFRS Roadmap:

1. Sufficient development and application of IFRS for the U.S. domestic reporting system.
2. The independence of standard setting for the benefit of investors.
3. Investor understanding and education regarding IFRS.
4. Examination of the U.S. regulatory environment that would be affected by a change in accounting standards.
5. The impact on users, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies.
6. Human capital readiness.

Each of these issues is significant. Moreover, the final staff report related to the work plan, issued July 13, 2012, is inconclusive. The report does not include a final policy decision (or even a recommendation) about whether IFRS should be incorporated into the U.S. financial reporting system. Hence, the future of IFRS in the U.S. is uncertain.

ACCOUNTING FOR DIFFERENCES IN CURRENCIES AND EXCHANGE RATES

Currency Definitions

Before discussing international transactions in detail, it is helpful to first understand some of the terms commonly used to describe different currencies. The ***local currency unit*** is the legal tender in the country or jurisdiction where an affiliated subsidiary is located. The

[3] Craig Karmin and Aaron Lucchetti, "New York Loses Edge in Snagging Foreign Listings," *The Wall Street Journal* (Eastern Edition), January 26, 2006, p. C1.

recording currency is the currency in which the company records its transactions. Finally, the ***reporting currency*** is the currency in which the financial reports will be presented to stakeholders. If a subsidiary is located in the United States, the local currency is the U.S. dollar. Transactions are recorded in dollars and the financial statements are reported in U.S. dollars. However, if for example, a U.S.-based parent company (which reports in U.S. dollars) owns a subsidiary located in Italy (where the local currency is the euro), it is likely that the subsidiary's recording currency will also be the euro. In order to consolidate this Italian subsidiary, the parent company domiciled in the United States will have to restate the Italian subsidiary's financial statements in dollars to facilitate the consolidation process. This chapter explains this process. The first step is to determine the functional currency.

DETERMINATION OF THE FUNCTIONAL CURRENCY

LO 12-2

Determine the functional currency and understand the ramifications of different functional currency designations.

Imagine that you received 100 British pounds sterling (£) in payment on an account in your London subsidiary on December 31, 20X1, and deposited it in a London bank. Assume that at the end of 20X1, the exchange rate is $1.80. To report the deposit on your 20X1 balance sheet stated in dollars, you would translate the deposit at the current rate and report an asset of $180. At the end of 20X2, assume you still have the £100 in the bank, but now the exchange rate is $1.70. To report the deposit on your 20X2 balance sheet, using the exchange rate at the end of 20X2, this amount would now translate into $170 and you would have an imbalance, also referred to as a ***translation adjustment,*** of $10 to deal with. If you translated at the historical rate, you would still translate into $180 and there would be no imbalance. Which is the correct exchange rate to use?

Date	Currency on Deposit	Current Exchange Rate	Dollar Equivalent
12/31/20X1	£100	$1.80	$180
12/31/20X2	100	1.70	170

Two major issues that must be addressed when financial statements are translated from a foreign currency into U.S. dollars are

1. Which exchange rate should be used to translate foreign currency balances to domestic currency?
2. How should translation gains and losses be accounted for? Should they be included in income?

Three possible exchange rates may be used in converting foreign currency values to the U.S. dollar. The ***current rate*** is the exchange rate at the end of the trading day on the balance sheet date. The ***historical rate*** is the exchange rate that existed when an initial transaction took place, such as the exchange rate on the date an asset was acquired or a liability was incurred. The ***average rate*** for the period is usually a simple average for a period of time and is usually the exchange rate used to measure revenues and expenses. Translation methods may employ a single rate or multiple rates. The translation adjustment created by the application of these exchange rates also must be reflected in the financial statements, as either a component of net income or a component of comprehensive income. The disposition of the translation adjustment will be discussed later in this chapter.

ASC 830 provides specific guidelines for translating a foreign currency into U.S. dollars to allow preparation of consolidated financial statements measured, or denominated, in dollars. The purpose of **ASC 830** is to present results that are directionally sympathetic to the real economic effects of exchange rate movements. Additionally, **ASC 830** seeks to preserve financial results and relationships in the foreign financial statements through the translation process. For instance, if the gross margin on sales is positive when measured in the foreign currency, it should still be positive when sales and cost of goods sold are translated into dollars. The FASB adopted the concept of the ***functional currency,***

FIGURE 12–1 Functional Currency Indicators

Indicator	Factors Indicating Foreign Currency (Local Currency) Is the Functional Currency	Factors Indicating U.S. Dollar (Parent's Currency) Is the Functional Currency
Cash flows	Primarily in foreign currency and do not affect parent's cash flows	Directly impact the parent's current cash flows and are readily available to the parent company
Sales prices	Primarily determined by local competition or local government regulation; not generally responsive to changes in exchange rates	Responsive to short-term changes in exchange rates and worldwide competition
Sales markets	Active local sales markets for company's products; possibly, significant amounts of exports	Sales markets mostly in parent's country, or sales contracts are denominated in parent's currency
Expenses	Labor, materials, and other costs are primarily local costs	Production components generally obtained from the parent company's country
Financing	Primarily obtained from, and denominated in, local currency units; entity's operations generate funds sufficient to service financing needs	Primarily from the parent, or other dollar-denominated financing
Intercompany transactions and arrangements	Few intercompany transactions with parent	Frequent intercompany transactions with parent, or foreign entity is an investment or financing arm for the parent

which is defined as "the currency of the primary economic environment in which the entity operates; normally that is the currency of the environment in which an entity primarily generates and receives cash."[4] The functional currency is used to differentiate between two types of foreign operations, those that are self-contained and integrated into a local environment and those that are an extension of the parent and integrated with the parent. A U.S. company may have foreign affiliates in many different countries. Each affiliate must be analyzed to determine its individual functional currency.

Refer to Figure 12–1 for the six indicators that must be assessed to determine an entity's functional currency: cash flows, sales prices, sales markets, expenses, financing, and intercompany transactions. If a foreign affiliate uses the local currency for most of its transactions, and if the cash generated is not regularly returned to the parent in the United States, the local currency is usually the functional currency. Also, the foreign affiliate usually has active sales markets in its own country and obtains financing from local sources.

Some foreign-based entities, however, use a functional currency different from the local currency. For example, a U.S. company's subsidiary in Venezuela may conduct virtually all of its business in Brazil, or a branch or a subsidiary of a U.S. company operating in Britain may well use the U.S. dollar as its major currency although it maintains its accounting records in British pounds sterling. The following factors indicate that the U.S. dollar is the functional currency for the British subsidiary: Most of its cash transactions are in U.S. dollars; its major sales markets are in the United States; production components are generally obtained from the United States; and the U.S. parent is primarily responsible for financing the British subsidiary.

The FASB adopted the functional currency approach after considering the following objectives of the translation process **(ASC 830)**:

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.

[4] **ASC 830-10-45 to 830-10-55.**

The functional currency approach requires the foreign entity to translate all of its transactions into its functional currency. If an entity has transactions denominated in other than its functional currency, the foreign transactions must be adjusted to their equivalent functional currency value before the company may prepare financial statements.

Functional Currency Designation in Highly Inflationary Economies

An exception to the criteria for selecting a functional currency is specified when the foreign entity is located in countries such as Argentina and Peru, which have experienced severe inflation. *Severe inflation* is defined as inflation exceeding 100 percent over a three-year period. The FASB concluded that the volatility of hyperinflationary currencies distorts the financial statements if the local currency is used as the foreign entity's functional currency. Therefore, in cases of operations located in highly inflationary economies, the reporting currency of the U.S. parent—the U.S. dollar—should be used as the foreign entity's functional currency. This exception prevents unrealistic asset values and income statement charges if the hyperinflation is ignored and normal translation procedures are used. For example, assume that a foreign subsidiary constructed a building that cost 1,000,000 pesos when the exchange rate was \$0.05 = 1 peso. Further assume that because of hyperinflation in the foreign subsidiary's country, the exchange rate becomes \$0.00005 = 1 peso. The translated values of the building at the time it was constructed and after the hyperinflation follow:

	Date of Construction		After Hyperinflation	
Amount (pesos)	Rate	Translated Amount	Rate	Translated Amount
1,000,000	\$0.05	\$50,000	\$0.00005	\$50

The translated values after the hyperinflation do not reflect the building's market value or historical cost. Thus, the FASB required the use of the U.S. dollar as the functional currency in cases of hyperinflation to give some stability to the financial statements.

Once a foreign affiliate's functional currency is chosen, it should be used consistently. However, if changes in economic circumstances necessitate a change in the designation of the foreign affiliate's functional currency, the accounting change should be treated as a change in estimate: current and prospective treatment only, no restatement of prior periods.

TRANSLATION VERSUS REMEASUREMENT OF FOREIGN FINANCIAL STATEMENTS[5]

LO 12-3

Understand and explain the differences between translation and remeasurement.

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Two different methods are used (in different circumstances) to restate foreign entity statements to U.S. dollars: (1) the ***translation*** of the foreign entity's functional currency statements into U.S. dollars and (2) the ***remeasurement*** of the foreign entity's statements into its functional currency. After remeasurement, the statements must then be translated if the functional currency is *not* the U.S. dollar. No additional work is needed if the functional currency is the U.S. dollar.

Translation is the most common method used and is applied when the local currency is the foreign entity's functional currency. This is the normal case in which, for example, a U.S. company's French subsidiary uses the euro as its recording and functional currency. The subsidiary's statements must be translated from euros into U.S. dollars. To translate the financial statements, the company will use the current rate, which is the exchange rate on the balance sheet date, to convert the local currency balance sheet account balances into U.S. dollars. Because revenues and expenses are assumed to occur uniformly over the period, revenues and expenses on the income statement are translated using the average

[5] To view a video explanation of this topic, visit advancedstudyguide.com.

rate for the reporting period. Any translation adjustment that occurs is a component of comprehensive income. The method used to translate financial statements from the local currency to U.S. dollars is called the ***current rate method.***

Remeasurement is the restatement of the foreign entity's financial statements from the local currency that the entity used into the foreign entity's functional currency. Remeasurement is required only when the functional currency is different from the currency used to maintain foreign entity's the books and records. For example, a relatively self-contained Canadian sales branch of a U.S. company may use the U.S. dollar as its functional currency but may select the Canadian dollar as its recording and reporting currency. Of course, if the Canadian branch uses the U.S. dollar for both its functional and reporting currency, no translation or remeasurement is necessary: Its statements are already measured in U.S. dollars and are ready to be combined with the U.S. home office statements.

The method used to remeasure the financial statements from the local currency to the functional currency is called the ***temporal method.*** Monetary assets and liabilities are those that represent rights to receive or obligations to pay a fixed number of foreign currency units in the future. Under the temporal method, the current rate is usually used to translate these monetary amounts to the functional currency. Nonmonetary items include fixed assets, long-term investments, and inventories. These items are usually translated at the historical rate that existed when the assets originally were purchased or the liability originally was incurred. Revenues and expenses on the income statement are translated using the average rate for the reporting period. Any imbalance that occurs because of the application of the temporal method is included in the calculation of net income on the income statement.

The application of the temporal method converts a foreign currency to the functional currency. If the functional currency is the U.S. dollar, no additional adjustments are needed. If the functional currency is something other than the U.S. dollar, the current rate method must be applied to restate the financial information in U.S. dollars.

One application of remeasurement is for affiliates located in countries experiencing hyperinflation. For example, an Argentinean subsidiary of a U.S. parent records and reports its financial statements in the local currency, the Argentine peso. However, because the Argentine economy experiences inflation exceeding 100 percent over a three-year period, the U.S. dollar is specified as the functional currency for reporting purposes and the subsidiary's statements must then be remeasured from Argentine pesos into U.S. dollars.

Three possible scenarios may require the restatement of financial statements from one currency to another via translation and/or remeasurement.

Case 1: The local currency is the functional currency. Simply translate the financial statements from the functional currency to the reporting currency. No further work is necessary because the consolidation and financial reports can now be prepared in the reporting currency.

Case 2: The local currency is not the functional currency, but the functional currency is the reporting currency. Simply remeasure the financial statements from the local currency to the functional currency. No further work is necessary because the consolidation and financial reports can now be prepared in the functional currency (because it is the reporting currency).

Case 3: The local currency is not the functional currency, and the functional currency is different from the reporting currency. First, remeasure the financial statements from the local currency to the functional currency. Second, translate the financial statements from the functional currency to the reporting currency so that the consolidation and financial statements can be prepared in the reporting currency.

The following examples illustrate a situation for each of these three cases in which restatement of the financial statements is not necessary.

Local Currency	Functional Currency	Reporting Currency	Restatement Method (s)
U.S. dollar (USD)	USD	USD	None
Case 1: Mexican peso (MP)	MP	USD	Translate from MP to USD
Case 2: British pound (BP)	USD	USD	Remeasure from BP to USD
Case 3: Uruguayan peso (UP)	Brazilian real (BR)	USD	Remeasure from UP to BR then translate from BR to USD

The conceptual reasons for the two different methods, translation and remeasurement, come from a consideration of the primary objective of the translation process: to provide information that shows the expected impact of exchange rate changes on the U.S. company's cash flows and equity. Foreign affiliates fall into two groups. Those in the first group are relatively self-contained entities that generate and spend local currency units. The local currency is the functional currency for this group of entities. These foreign affiliates may reinvest the currency they generate or may distribute funds to their home office or parent company in the form of dividends. Exchange rate changes do not directly affect the U.S. parent company's cash flows but do affect the foreign affiliate's net assets (assets minus liabilities) and, therefore, the U.S. parent company's net investment in the entity. Translation is appropriate for these firms' financial statements.

The second group of foreign affiliates is made up of entities that are extensions of the U.S. company. These affiliates operate in a foreign country but are directly affected by changes in exchange rates because they depend on the U.S. economy for sales markets, production components, or financing. For this group, the U.S. dollar is the functional currency. There is a presumption that the effect of exchange rate changes on the foreign affiliate's net assets will directly affect the U.S. parent company's cash flows, so the exchange rate adjustments are reported in the U.S. parent's income. Remeasurement is appropriate for these firms' financial statements.

Translation and remeasurement include different adjustment procedures and may result in significantly different consolidated financial statements. We illustrate both methods in this chapter.

! CAUTION

Knowing when to translate and when to remeasure can be difficult. To ensure that you do not become confused, the following rule of thumb can be useful in determining how to restate a U.S.-based parent company's foreign subsidiary's financial statements:

If LC = FC, translate to USD
If LC ≠ FC, remeasure to FC

- If FC = USD, no further work is needed
- If FC ≠ USD, translate to USD

Where:

LC = local currency
FC = functional currency
USD = U.S. dollars

TRANSLATION OF FUNCTIONAL CURRENCY STATEMENTS INTO THE REPORTING CURRENCY OF THE U.S. COMPANY

LO 12-4

Make calculations and translate financial statements of a foreign subsidiary.

Most business entities transact and record business activities in the local currency. Therefore, the foreign entity's local currency is its functional currency. The translation of the foreign entity's statement into U.S. dollars is a relatively straightforward process.

The FASB believes that the underlying economic relationships presented in the foreign entity's financial statements should not be distorted or changed during the translation process from the foreign entity's functional currency into the currency of the U.S. parent. For example, if the foreign entity's functional currency statements report a current ratio of 2:1 and a gross margin of 60 percent of sales, these relationships should pass through the translation process into the U.S. parent's reporting currency. It is important to be able to evaluate the performance of the foreign entity's management with the same economic measures used to operate it. To maintain the economic relationships in the functional currency statements, the account balances must be translated by a comparable exchange rate.

The translation is made by using the current exchange rate for *all* assets and liabilities. This rate is the spot rate on the balance sheet date. The income statement items—revenue, expenses, gains, and losses—should be translated at the exchange rate on the dates on which the underlying transactions occurred, although for practical purposes, an average exchange rate for the period may be used for these items with the assumption that revenues and expenses are recognized evenly over the period. However, if a material gain or loss results from a specific event, the exchange rate on the date of the event rather than the average exchange rate should be used to translate the transaction results.

The stockholders' equity accounts, other than retained earnings, are translated at historical exchange rates. The appropriate historical rate is the rate on the latter of the date the parent company acquired the investment in the foreign entity or the date the subsidiary had the stockholders' equity transaction. This is necessary to complete the elimination of the parent company's investment account against the foreign subsidiary's capital accounts in the consolidation process. The subsidiary's translated retained earnings are carried forward from the previous period with additions for this period's income and deductions for dividends declared during the period. Dividends are translated at the exchange rate on the date of declaration. It is interesting to observe that if the foreign entity has not paid its declared dividend by the end of its fiscal period, it has a dividends payable account that is translated at the current rate. Nevertheless, the dividend deduction from retained earnings is translated using the exchange rate on the date of dividend declaration.

In summary, the translation of the foreign entity's financial statements from its functional currency into the reporting currency of the U.S. company is made as follows:

Income statement accounts:	
Revenue and expenses	Generally, average exchange rate for period covered by statement
Balance sheet accounts:	
Assets and liabilities	Current exchange rate on balance sheet date
Stockholders' equity	Historical exchange rates

Because various rates are used to translate the foreign entity's individual accounts, the trial balance debits and credits after translation generally are not equal. The balancing item to make the translated trial balance debits equal the credits is called the ***translation adjustment.***

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Financial Statement Presentation of Translation Adjustment

The translation adjustment resulting from the translation process is part of the entity's comprehensive income for the period. **ASC 220** defines comprehensive income to include all changes in equity during a period except those resulting from investments by owners

and distributions to owners. ***Comprehensive income*** includes net income and ***"other comprehensive income"*** items that are part of the changes in the net assets of a business enterprise from nonowner sources (e.g., not additional capital investments and dividends) during a period. **ASC 220** requires the reporting of comprehensive income as part of the entity's primary financial statements. The major items of the other comprehensive income items are the changes during the period in foreign currency translation adjustments, unrealized gains or losses on available-for-sale securities, revaluation of cash flow hedges, and adjustments in the minimum pension liability item.

Each period's other comprehensive income (OCI) is closed to ***accumulated other comprehensive income*** (AOCI), which is displayed separately from other stockholders' equity items (e.g., capital stock, additional paid-in capital, and retained earnings). The statement of changes in stockholders' equity opens with the accumulated balance of the other comprehensive income items at the beginning of the period, then includes the change in the translation adjustment and the additional other comprehensive income items during the period that were included in the period's comprehensive income, and ends with the accumulated other comprehensive income balance at the end of the period. The accumulated ending balance of the other comprehensive income items is then reported in the entity's balance sheet as part of the stockholders' equity section, usually after retained earnings. The discussion of the disclosure requirements presented later in this chapter demonstrates the financial statements for the Peerless Products Corporation example presented in the chapter.

LO 12-5

Prepare consolidated financial statements including a foreign subsidiary after translation.

Illustration of Translation and Consolidation of a Foreign Subsidiary

To examine the consolidation of a foreign subsidiary, assume the following facts:[6]

1. On January 1, 20X1, Peerless, a U.S. company, purchased 100 percent of the outstanding capital stock of German Company, a firm located in Berlin, Germany, for $63,000, which is $3,000 above book value. (The proof of the differential is shown at the end of the next section of the chapter.) The excess of cost over book value is attributable to a patent amortizable over 10 years. Balance sheet accounts in a trial balance format for both companies immediately *before* the acquisition are presented in Figure 12–2.
2. The local currency for German Company is the euro (€), which is also its functional currency.
3. On October 1, 20X1, the subsidiary declared and paid dividends of €6,250.
4. The subsidiary received $4,200 in a sales transaction with a U.S. company when the exchange rate was $1.20 = €1. The subsidiary still has this foreign currency on December 31, 20X1.
5. Relevant direct spot exchange rates ($/€1) are:

Date	Rate
January 1, 20X1	$1.20
October 1, 20X1	1.36
December 31, 20X1	1.40
20X1 average	1.30

Date-of-Acquisition Translation Worksheet

Figure 12–3 presents the translation of German Company's trial balance on January 1, 20X1. This illustration assumes that the subsidiary's books and records are maintained in European euros, the subsidiary's functional currency.

[6] The Chapter 11 examples illustrate the effects of a dollar that strengthens against the euro during 20X1. In the examples for the remainder of this chapter, the dollar weakens against the euro during 20X1. Thus, in Chapters 11 and 12, changes in exchange rates in both directions will have been illustrated.

FIGURE 12–2
Balance Sheet Accounts for the Two Companies on January 1, 20X1 (immediately before acquisition of 100 percent of German Company's stock by Peerless Products, a U.S. company)

	Peerless Products	German Company
Cash	$ 350,000	€ 2,500
Receivables	75,000	10,000
Inventory	100,000	7,500
Land	175,000	0
Plant & Equipment	800,000	50,000
Total Debits	$1,500,000	€70,000
Accumulated Depreciation	$ 400,000	€ 5,000
Accounts Payable	100,000	2,500
Bonds Payable	200,000	12,500
Common Stock	500,000	40,000
Retained Earnings, 12/31/X0	300,000	10,000
Total Credits	$1,500,000	€70,000

FIGURE 12–3
Worksheet to Translate Foreign Subsidiary on January 1, 20X1 (date of acquisition)
Functional Currency
Is the European Euro

Item	Trial Balance, €	Exchange Rate, $/€	Trial Balance, $
Cash	2,500	1.20	3,000
Receivables	10,000	1.20	12,000
Inventory	7,500	1.20	9,000
Plant & Equipment	50,000	1.20	60,000
Total Debits	70,000		84,000
Accumulated Depreciation	5,000	1.20	6,000
Accounts Payable	2,500	1.20	3,000
Bonds Payable	12,500	1.20	15,000
Common Stock	40,000	1.20	48,000
Retained Earnings	10,000	1.20	12,000
Total Credits	70,000		84,000

Note: $1.20 is the direct exchange rate on January 1, 20X1.

The translation of the subsidiary's trial balance from the functional currency (€) into dollars, the U.S. parent's reporting currency, is made using the *current rate method.* Under acquisition accounting, the subsidiary's stockholders' equity accounts are translated using the current rate on the date the parent company purchased the subsidiary's stock.

Peerless Products makes this entry to record the purchase of 100 percent of German Company's stock:

January 1, 20X1

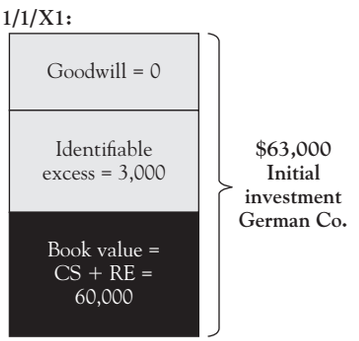
(1)	Investment in German Company Stock	63,000	
	Cash		63,000

Purchase of German Company Stock.

The differential on January 1, 20X1, the date of acquisition, is computed as follows:

	Fair value of consideration		$63,000
	Book value of shares acquired:		
1/1/X1	Common stock—German Co.	$48,000	
100%	Retained earnings—German Co.	12,000	
	Total	$60,000	
	Percent of German Company's stock acquired by Peerless Corporation	× 1.00	
	Book value acquired by Peerless Corporation		60,000
	Difference between fair value and book value		$ 3,000

A graphic representation of the acquisition is as follows:



Date-of-Acquisition Consolidated Balance Sheet

To prepare the elimination entries, we begin by analyzing the book value of the investment in German Company:

Book Value Calculations:

	Peerless 100%	=	Common Stock	+	Retained Earnings
Book value at acquisition date	60,000		48,000		12,000

This leads to the basic elimination entry:

Basic Elimination Entry:

Common stock	48,000		← Common stock balance
Retained earnings	12,000		← Beginning balance in retained earnings
Investment in German Co.		60,000	← Net book value in investment account

The differential is entirely attributable to the patent, $3,000, so the excess value reclassification entry is as follows:

Excess Value Reclassification Entry:

Patent	3,000		← Excess value assigned to patent
Investment in German Co.		3,000	← Reclassify excess acquisition price

These two worksheet entries eliminate the balance in Peerless' investment account and the second entry assigns the differential to the patent account.

	Investment in German Co.		
Acquisition Price	63,000		
		60,000	Basic elimination entry
		3,000	Excess value reclassification entry
	0		

Finally, we include the optional accumulated depreciation elimination entry:

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	6,000		← Accumulated depreciation at the time of the acquisition netted against cost
Building and equipment		6,000	

Figure 12–4 presents the consolidation worksheet on the acquisition date.

FIGURE 12–4 January 1, 20X1, Worksheet for Consolidated Balance Sheet, Date of Acquisition
100 Percent Purchase at More Than Book Value

	Peerless Products	German Company	Elimination Entries DR	Elimination Entries CR	Consolidated
Balance Sheet					
Cash	287,000	3,000			290,000
Receivable	75,000	12,000			87,000
Inventory	100,000	9,000			109,000
Investment in German Co. Stock	63,000			**60,000**	0
				3,000	
Patent			**3,000**		3,000
Land	175,000				175,000
Plant & Equipment	800,000	60,000		**6,000**	854,000
Less: Accumulated Depreciation	(400,000)	(6,000)	**6,000**		(400,000)
Total Assets	**1,100,000**	**78,000**	**9,000**	**69,000**	**1,118,000**
Accounts Payable	100,000	3,000			103,000
Bonds Payable	200,000	15,000			215,000
Common Stock	500,000	48,000	**48,000**		500,000
Retained Earnings	300,000	12,000	**12,000**		300,000
Total Liabilities & Equity	**1,100,000**	**78,000**	**60,000**	**0**	**1,118,000**

Subsequent to Date of Acquisition

The accounting subsequent to the date of acquisition is very similar to the accounting used for domestic subsidiaries. The major differences are due to the effects of changes in the exchange rates of the foreign currency.

Translation of Foreign Subsidiary's Postacquisition Trial Balance

Figure 12–5 illustrates the translation of German Company's December 31, 20X1, trial balance.

Note the account Foreign Currency Units the German subsidiary's trial balance. This account represents the $4,200 of U.S. dollars held by the subsidiary. Because this account is denominated in a currency other than the subsidiary's reporting currency, German Company made an adjusting journal entry to revalue the account from the amount originally recorded using the exchange rate on the date the company received the currency to that amount's equivalent exchange value at the end of the year.

The subsidiary made the following entry on its books when it received the U.S. dollars:

(2)	Foreign Currency Units ($)	3,500	
	Sales		3,500

Record sales and receipt of 4,200 U.S. dollars at spot exchange rate on the date of receipt: €3,500 = $4,200/$1.20 exchange rate.

At the end of the period, the subsidiary adjusted the foreign currency units (the U.S. dollars) to the current exchange rate ($1.40 = €1) by making the following entry:

(3)	Foreign Currency Transaction Loss	500	
	Foreign Currency Units ($)		500

Adjust account denominated in foreign currency units to current exchange rate:

$4,200/$1.40	€3,000
Less: Preadjusted balance	(3,500)
Foreign currency transaction loss	€ (500).

FIGURE 12–5
December 31, 20X1, Translation of Foreign Subsidiary's Trial Balance
European Euro Is the Functional Currency

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Item	Balance, €	Exchange Rate	Balance, $
Cash	10,750	1.40	15,050
Foreign Currency Units	3,000	1.40	4,200
Receivables	10,500	1.40	14,700
Inventory	5,000	1.40	7,000
Plant & Equipment	50,000	1.40	70,000
Cost of Goods Sold	22,500	1.30	29,250
Operating Expenses	14,500	1.30	18,850
Foreign Currency Transaction Loss	500	1.30	650
Dividends Paid	6,250	1.36	8,500
Total Debits	123,000		168,200
Accumulated Depreciation	7,500	1.40	10,500
Accounts Payable	3,000	1.40	4,200
Bonds Payable	12,500	1.40	17,500
Common Stock	40,000	1.20	48,000
Retained Earnings (1/1)	10,000	(*a*)	12,000
Sales	50,000	1.30	65,000
Total	123,000		157,200
Accumulated Other Comprehensive Income—Translation Adjustment			11,000
Total Credits			168,200

(*a*) From the January 1, 20X1, translation worksheet.

The foreign currency transaction loss is a component of the subsidiary's net income, and the Foreign Currency Units account is classified as a current asset on the subsidiary's balance sheet. The subsidiary's net income consists of the following elements:

Sales	€ 50,000
Cost of Goods Sold	(22,500)
Operating Expenses	(14,500)
Foreign Currency Transaction Loss	(500)
Net Income	€ 12,500

Because the European euro is the foreign entity's functional currency, the subsidiary's statements must be translated into U.S. dollars using the current rate method. The assets and liabilities are translated using the current exchange rate at the balance sheet date ($1.40), the income statement accounts are translated using the average rate for the period ($1.30), and the stockholders' equity accounts are translated using the appropriate historical exchange rates ($1.20 and $1.36). The dividends are translated at the October 1 rate ($1.36), which was the exchange rate on the date the dividends were declared. The example assumes the dividends were paid on October 1, the same day they were declared. If the dividends had not been paid by the end of the year, the liability dividends payable would be translated at the current exchange rate of $1.40 = €1.

One of the analytical features provided by the current rate method is that many of the ratios management uses to manage the foreign subsidiary are the same in U.S. dollars as they are in the foreign currency unit. This relationship is true for the assets and liabilities of the balance sheet and the revenue and expenses of the income statement because the translation for these accounts uses the same exchange rate—the current rate for the assets and liabilities, and the average exchange rate for the income statement accounts. Thus, the *scale* of these accounts has changed but not their *relative amounts* within their respective statements. This relationship is not true when the ratio includes numbers from both the income statement and the balance sheet or when a stockholders' equity account is

included with an asset or liability. The following table illustrates the relative relationships within the financial statements using the data in Figure 12–5:

	Measured in €	Measured in U.S. $
Current ratio:		
Current assets	€29,250	$40,950
Current liabilities	3,000	4,200
Current ratio	9.75	9.75
Cost of goods sold as a percentage of sales:		
Cost of goods sold	€22,500	$29,250
Sales	50,000	65,000
Percent	45%	45%

The translation adjustment in Figure 12–5 arises because the investee's assets and liabilities are translated at the current rate whereas other rates are used for the stockholders' equity and income statement account balances. Although the translation adjustment may be thought of as a balancing item to make the trial balance debits equal the credits, the effects of changes in the exchange rates during the period should be calculated to prove the accuracy of the translation process. This proof for 20X1, the acquisition year, is provided in Figure 12–6.

The proof begins with the determination of the effect of changes in the exchange rate on the beginning investment and on the elements that alter the beginning investment. Note that only events affecting the stockholders' equity accounts will change the net assets investment. In this example, the changes to the investment account occurred from income of €12,500 and dividends of €6,250. No changes occurred in the stock outstanding during the year. The beginning net investment is translated using the exchange rate at the beginning of the year. The income and dividends are translated using the exchange rate at the date the transactions occurred. The income was earned evenly over the year; thus, the average exchange rate for the period is used to translate income. The ending net assets position is translated using the exchange rate at the end of the year. The cumulative translation adjustment at the beginning of the year is zero in this example because the subsidiary was acquired on January 1, 20X1.

The Accumulated Other Comprehensive Income—Translation Adjustment account has a credit balance because the spot exchange rate at the end of the first period of ownership is higher than the exchange rate at the beginning of the period or the average for the period. If the exchange rate had decreased during the period, the translation adjustment would have had a debit balance. Another way of determining whether the accumulated

FIGURE 12–6
Proof of Translation Adjustment as of December 31, 20X1
European Euro Is the Functional Currency

PEERLESS PRODUCTS AND SUBSIDIARY
Proof of Translation Adjustment
Year Ended December 31, 20X1

	€	Translation Rate	$
Net assets at beginning of year	50,000	1.20	60,000
Adjustment for changes in net assets position during year:			
Net income for year	12,500	1.30	16,250
Dividends paid	(6,250)	1.36	(8,500)
Net assets translated at:			
Rates during year			67,750
Rates at end of year	56,250	1.40	78,750
Change in other comprehensive income—net translation adjustment during year			11,000
Accumulated other comprehensive income—translation adjustment, 1/1			0
Accumulated other comprehensive income—translation adjustment, 12/31 (credit)			11,000

translation adjustment has a debit or credit balance is to use balance sheet logic. For example, the subsidiary's translated balance sheet at the beginning of the year would be

Translated Balance Sheet, 1/1/X1			
Net assets	$60,000	Common stock	$48,000
		Retained earnings	12,000
Total	$60,000	Total	$60,000

The translated balance sheet at the end of the year would be:

Translated Balance Sheet, 12/31/X1			
Net assets	$78,750	Common stock	$48,000
		Retained earnings	19,750
		Accumulated other comprehensive income—translation adjustment	11,000
Total	$78,750	Total	$78,750

Note that the $11,000 is a credit balance in order to make the balance sheet "balance."

Entries on Parent Company's Books

The parent company makes entries on its books to recognize the dollar equivalent values of its share of the subsidiary's income, amortization of the excess of cost over book value, a cumulative translation adjustment for the parent's differential, and the dividends received from the foreign subsidiary. In addition, the parent company must recognize its share of the translation adjustment arising from the translation of the subsidiary's financial statements. The periodic change in the parent company's translation adjustment from the foreign investment is reported as a component of the parent company's other comprehensive income.

The entries that Peerless Products makes to account for its investment in German Company follow. Peerless Products received the dividend on October 1, 20X1, and immediately converted it to U.S. dollars as follows:

October 1, 20X1

(4)	Cash	8,500	
	Investment in German Company Stock		8,500

Dividend received from foreign subsidiary: €6,250 × $1.36 exchange rate.

December 31, 20X1

(5)	Investment in German Company Stock	16,250	
	Income from Subsidiary		16,250

Equity in net income of German Co.: €12,500 × $1.30 average exchange rate.

(6)	Investment in German Company Stock	11,000	
	Other Comprehensive Income—Translation Adjustment		11,000

Parent's share of change in translation adjustment from translation of subsidiary's accounts: $11,000 × 1.00.

If some time passed between the declaration and payment of dividends, the parent company would record dividends receivable from the foreign subsidiary on the declaration date. This account would be denominated in a foreign currency and would be adjusted to its current exchange rate on the balance sheet date and on the payment date, just like any other account denominated in a foreign currency. Any foreign transaction gain or loss resulting from the adjustment procedure would be included in the parent's income for the period.

The Differential

The allocation and amortization of the excess of cost over book value require special attention in the translation of a foreign entity's financial statements. The differential does not exist on the foreign subsidiary's books; it is part of the parent's investment account. However, the translated book value of the foreign subsidiary is a major component of the investment account on the parent's books and is directly related to a foreign-based asset. **ASC 830** requires that the allocation and amortization of the difference between the investment cost and its book value be made in terms of the foreign subsidiary's functional currency and that these amounts then be translated at the appropriate exchange rates on the worksheet balance sheet date. The periodic amortization affects the income statement and is therefore measured at the average exchange rate used to translate other income statement accounts. On the other hand, the remaining unamortized balance of the differential is reported in the balance sheet and is translated at the current exchange rate used for balance sheet accounts. The effect of this difference in rates is shown in the parent company's translation adjustment as a revision of part of its original investment in the subsidiary.

Peerless Products amortizes the patent over a five-year period. The patent amortization follows.

	European Euros (€)	Translation Rate	U.S. Dollars ($)
Income Statement			
Differential at beginning of year	2,500	1.20	3,000
Amortization this period (€5,000/5 years)	(500)	1.30	(650)
Remaining balances	2,000		2,350
Balance Sheet			
Remaining balance on 12/31/X1 translated at year-end exchange rates	2,000	1.40	2,800
Difference to other comprehensive income—translation adjustment (credit)			450

Another way to view the $450 differential adjustment is that it adjusts the parent company's differential, which is currently part of the investment account, to the amount necessary to prepare the consolidated balance sheet. In this example, if no differential adjustment is made, the patent on the consolidated balance sheet would be $2,350, which is incorrect. Because the balance sheet must report the patent translated at the end-of-period exchange rate of $2,800, the differential adjustment is made to properly report the amount in the consolidated balance sheet. Thus, the adjustment may be thought of as an adjustment necessary to obtain the correct amount of the differential to prepare the consolidated balance sheet. Depending on the direction of the changes in the exchange rate, the differential adjustment could be a debit or credit amount. In this case, the differential must be increased from $2,350 to $2,800, necessitating a $450 debit to the investment account and a corresponding credit to the Other Comprehensive Income—Translation Adjustment account.

Entry (7) recognizes the amortization of the patent for the period. Entry (8) records the portion of the translation adjustment on the increase in the differential for the investment in the foreign subsidiary.

(7)

Income from Subsidiary	650	
Investment in German Company Stock		650

Amortization of patent: $650 = €500 × $1.30 average exchange rate.

(8)

Investment in German Company Stock	450	
Other Comprehensive Income—Translation Adjustment		450

Recognize translation adjustment on increase in differential.

This $450 translation adjustment is attributable to the excess of cost paid over the book value of the assets and therefore is added to the differential, which is a component of the investment in the foreign subsidiary, thereby resulting in a debit to the investment account on the parent company's books.

The December 31, 20X1, balance in the Investment in German Company Stock account is $81,550 and the balance in Income from German Company is $15,600, as shown in the following T-accounts. A series of four worksheet entries (explained below) eliminates both accounts in the consolidation process.

	Investment in German Company			Income from German Company		
Acquisition 1/1/X1	63,000					
100% Net Income	16,250				16,250	100% Net Income
		8,500	100% Dividends			
German Co. Translation	11,000	650	Excess Value	650		
Differential Translation	450		Amortization			
Balance 12/31/X1	81,550				15,600	Balance 12/31/X1
		67,750	Basic	16,250		
		2,800	Excess Reclass.		650	Excess Value Reclass.
		11,000	OCI			
	0				0	

Note that the $11,450 Other Comprehensive Income—Translation Adjustment account balance in the parent company's books is composed of its share of the translation adjustment from translating the subsidiary's trial balance ($11,000) plus the parent company's adjustment ($450) due to the differential it paid for the investment.

During the parent company's closing entries process, the following two entries would be included to separately close net income from the subsidiary and the other comprehensive income arising from its investment in the subsidiary.

(9)

Income from Subsidiary	15,600	
Retained Earnings		15,600

To close net income from subsidiary:
$15,600 = $16,250 − $650.

(10)

Other Comprehensive Income—Trans. Adjustment	11,450	
Accumulated OCI—Translation Adjustment		11,450

To close other comprehensive income resulting from the investment in the German subsidiary:
$11,450 = $11,000 + $450.

Subsequent Consolidation Worksheet

The consolidation worksheet is prepared after the translation process is completed. The consolidation process is the same as for a domestic subsidiary except for two major differences: (1) The parent company will record its share of the translation adjustment arising from the translation of the foreign subsidiary's accounts. In this example, the parent owns 100 percent of the subsidiary, but, in cases of a less-than-wholly-owned subsidiary, the noncontrolling interest would be assigned its percentage share of the translation adjustment and (2) as shown previously, the patent amortization for the period is translated at the income statement rate (average for the period) whereas the ending patent balance is translated at the balance sheet rate (current exchange rate).Thus, a translation adjustment must be computed on the differential and assigned as part of the parent company's investment in the foreign subsidiary.

To prepare the elimination entries, we begin by analyzing the book value of the investment in German Company:

Book Value Calculations:

	Peerless 100%	=	Common Stock	+	Retained Earnings
Beginning book value	60,000		48,000		12,000
+ Net Income	16,250				16,250
− Dividends	(8,500)				(8,500)
Ending book value	67,750		48,000		19,750

This leads to the basic elimination entry:

Basic Elimination Entry:

Common stock	48,000		← Common stock balance
Retained earnings	12,000		← Beginning balance in retained earnings
Income from German Co.	16,250		← German Company's reported income
Dividends declared		8,500	← 100% of German's dividends declared
Investment in German Co.		67,750	← Net book value in investment account

The $3,000 differential is entirely attributable to the patent; nevertheless, because it arises from the acquisition of a foreign subsidiary, we provide these calculations that illustrate the translation adjustment for the differential:

Excess Value (differential) Calculation:

	Total Excess	=	Patent
Beginning excess value	3,000		3,000
− Amortization of differential	(650)		(650)
+ Differential translation adjustment	450		450
Ending excess value	2,800		2,800

Note that the adjustments for $650 and $450 were already explained in entries (7) and (8).

Amortized Excess Value Reclassification Entry:

Operating expense	650		← Amortization of patent
Income from German Co.		650	← Elimination of patent amortization

Excess Value (differential) Reclassification Entry:

Patent	2,800		← Excess value assigned to patent
Investment in German Co.		2,800	← Reclassify excess acquisition price

In addition, we record the other comprehensive income entry illustrated in Chapter 5:

Other Comprehensive Income Entry:

OCI from German Co.	11,000	
Investment in German Co.		11,000

Finally, we include the optional accumulated depreciation elimination entry:

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	6,000		← Accumulated depreciation at the time of the acquisition netted against cost
Building and equipment		6,000	

FIGURE 12–7 December 31, 20X1, Consolidation Worksheet, Prepared after Translation of Foreign Statements

	Peerless Products	German Company	Elimination Entries DR	Elimination Entries CR	Consolidated
Income Statement					
Sales	400,000	65,000			465,000
Less: COGS	(170,000)	(29,250)			(199,250)
Less: Operating Expenses	(90,000)	(18,850)	650		(109,500)
Less: Foreign Currency Transaction Loss		(650)			(650)
Income from German Co.	15,600		16,250	650	0
Net Income	**155,600**	**16,250**	**16,900**	**650**	**155,600**
Statement of Retained Earnings					
Beginning Balance	300,000	12,000	12,000		300,000
Net Income	**155,600**	**16,250**	**16,900**	**650**	155,600
Less: Dividends Declared	(60,000)	(8,500)		8,500	(60,000)
Ending Balance	**395,600**	**19,750**	**28,900**	**9,150**	**395,600**
Balance Sheet					
Cash	425,500	15,050			440,550
Dollars Held by German Company		4,200			4,200
Receivables	75,000	14,700			89,700
Inventory	100,000	7,000			107,000
Investment in German Company Stock	81,550			67,750	0
				2,800	
				11,000	
Land	175,000				175,000
Patent			2,800		2,800
Plant & Equipment	800,000	70,000		6,000	864,000
Less: Accumulated Depreciation	(450,000)	(10,500)	6,000		(454,500)
Total Assets	**1,207,050**	**100,450**	**8,800**	**87,550**	**1,228,750**
Accounts Payable	100,000	4,200			104,200
Bonds Payable	200,000	17,500			217,500
Common Stock	500,000	48,000	48,000		500,000
Retained Earnings	**395,600**	**19,750**	**28,900**	**9,150**	395,600
Accumulated Other Comprehensive Income	11,450	11,000	**11,000**	**0**	11,450
Total Liabilities & Equity	**1,207,050**	**100,450**	**87,900**	**9,150**	**1,228,750**
Other Comprehensive Income					
Accumulated Other Comprehensive Income, 1/1/X1	0	0			0
Other Comprehensive Income Translation Adjustment	11,450	11,000	11,000		11,450
Accumulated Other Comprehensive Income, 12/31/X1	**11,450**	**11,000**	**11,000**	**0**	**11,450**

See Figure 12–7 for the worksheet. The trial balance for German Company is obtained from the translated amounts computed earlier in Figure 12–5. The worksheet entries follow in journal entry form. These entries are *not* made on either company's books; they are only in the worksheet elimination columns.

When the parent company uses the equity method and no intercompany revenue transactions occur, the parent's net income and retained earnings equal the consolidated net income and consolidated retained earnings. This makes it possible to verify the amounts reported on the consolidated financial statements.

FIGURE 12–8 Consolidated Statement of Changes in Stockholders' Equity

PEERLESS PRODUCTS AND SUBSIDIARY
Consolidated Statement of Changes in Equity
Year Ended December 31, 20X1

	Total	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income	Capital Stock
Beginning Balance	$800,000		$300,000	$ 0	$500,000
Comprehensive Income:					
Net Income	155,600	$155,600	155,600		
Other Comprehensive Income:					
Foreign Currency Translation Adjustment	11,450	11,450		11,450	
Comprehensive Income		$167,050			
Dividends Declared on Common Stock	(60,000)		(60,000)		
Ending Balance	$907,050		$395,600	$11,450	$500,000

Noncontrolling Interest of a Foreign Subsidiary

Most U.S. companies prefer to own 100 percent of their foreign subsidiaries. Doing so provides for more efficient management of the subsidiary and no requirement to prepare separate financial statements of the subsidiary for a noncontrolling interest. If a foreign subsidiary was less than wholly owned, however, the noncontrolling interest would be computed and accounted for just as it was in Chapter 3 of this text. The only difference is the allocation of the translation adjustment that arises from the translation of the foreign subsidiary's trial balance accounts. Thus, for example, if Peerless had an 80 percent interest in German Company and another investor owned a 20 percent noncontrolling interest, the noncontrolling interest would be allocated its percentage share of the translation adjustment through the elimination entry process. The noncontrolling interest on the consolidated balance sheet at year-end would include its share of the accumulated other comprehensive income from the translation adjustment, as follows:

Common stock ($48,000 × 0.20)		$ 9,600
Retained earnings:		
Beginning retained earnings ($12,000 × 0.20)	$2,400	
Add: Net income ($16,250 × 0.20)	3,250	
Less: Dividends ($8,500 × 0.20)	(1,700)	
Total retained earnings		3,950
Accumulated other comprehensive income— translation adjustment ($11,000 × 0.20)		2,200
Total noncontrolling interest		$15,750

Figure 12–8's consolidated statement of changes in stockholder's equity shows how the income statement and other comprehensive income accounts flow to the balance sheet's equity ending balances.

REMEASUREMENT OF THE BOOKS OF RECORD INTO THE FUNCTIONAL CURRENCY

LO 12-6

Make calculations and remeasure financial statements of a foreign subsidiary.

A second method of restating foreign affiliates' financial statements in U.S. dollars is remeasurement. Although remeasurement is not as commonly used as translation, some situations in which the foreign affiliate's functional currency is not its local currency exist. Remeasurement is similar to translation in that its goal is to obtain equivalent U.S.

dollar values for the foreign affiliate's accounts so they may be combined or consolidated with the U.S. company's statements. The exchange rates used for remeasurement, however, are different from those used for translation, resulting in different dollar values for the foreign affiliate's accounts.

The FASB provided examples of several situations requiring remeasurement:[7]

1. A foreign sales branch or subsidiary of a U.S. manufacturer that primarily takes orders from foreign customers for U.S.-manufactured goods, that bills and collects from foreign customers, and that might have a warehouse to provide for timely delivery of the product to those foreign customers. In substance, this foreign operation may be the same as the export sales department of a U.S. manufacturer.
2. A foreign division, branch, or subsidiary that primarily manufactures a subassembly shipped to a U.S. plant for inclusion in a product that is sold to customers located in the United States or in different parts of the world.
3. A foreign shipping subsidiary that primarily transports ore from a U.S. company's foreign mines to the United States for processing in a U.S. company's smelting plants.
4. A foreign subsidiary that is primarily a conduit for euro borrowings to finance operations in the United States.

In most cases, the foreign affiliate may be thought of as a direct production or sales arm of the U.S. company, but it uses the local currency to record and report its operations. In addition, foreign entities located in highly inflationary economies, defined as economies having a cumulative three-year inflation rate exceeding 100 percent, must use the dollar as their functional currency, and their statements are remeasured into U.S. dollars. Many South American countries have experienced hyperinflation with some countries having annual inflation rates in excess of 100 percent. If the foreign affiliate uses the U.S. dollar as both its functional and its reporting currency, no remeasurement is necessary because its operations are already reported in U.S. dollars.

The remeasurement process should produce the same end result as if the foreign entity's transactions had been initially recorded in dollars. For this reason, certain transactions and account balances are restated to their U.S.–dollar equivalents using a historical exchange rate, the spot exchange rate at the time the transaction originally occurred. The remeasurement process divides the balance sheet into monetary and nonmonetary accounts. Monetary assets and liabilities such as cash, short-term or long-term receivables, and short-term or long-term payables have their amounts fixed in terms of the units of currency. They represent amounts that will be received or paid in a fixed number of monetary units. Note that an exception to the general statement in Figure 12-9 about marketable securities applies to trading and available-for-sale securities. Because they are marked to market at each reporting date, they are considered monetary assets and are remeasured using current rates. These accounts are subject to gains or losses from changes in exchange rates. Nonmonetary assets are accounts such as inventories and plant and equipment, which are not fixed in relation to monetary units.

The monetary accounts are remeasured using the current exchange rate. The appropriate historical exchange rate is used to remeasure nonmonetary balance sheet account balances and related revenue, expense, gain, and loss account balances. A list of the accounts to be remeasured with the appropriate historical exchange rate is provided in Figure 12–9 **(ASC 830-10-45-18)**.

Because of the variety of rates used to remeasure the foreign currency trial balance, the debits and credits of the U.S. dollar–equivalent trial balance will probably not be equal. In this case, the balancing item is a ***remeasurement gain or loss,*** which is included in the period's income statement (i.e., not in other comprehensive income).

[7] These examples were provided in the exposure draft of **ASC 830** but were not included in its final draft. The FASB did not want the examples to limit remeasurement to those cases in which the U.S. dollar is the functional currency.

FIGURE 12–9
Accounts to Be Remeasured Using Historical Exchange Rates

Examples of Balance Sheet Nonmonetary Items
Marketable securities:
Equity securities
Debt securities not intended to be held until maturity
Inventories
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 Revenue and Expenses Related to Nonmonetary Items
Cost of goods sold
Depreciation of property, plant, and equipment
Amortization of intangible items such as patents, licenses, etc.
Amortization of deferred charges or credits, except deferred income taxes and policy acquisition costs for life insurance companies

Statement Presentation of Remeasurement Gain or Loss

Any exchange gain or loss arising from the remeasurement process is included in the current period income statement, usually under "Other Income." Various account titles are used, such as Foreign Exchange Gain (Loss), Currency Gain (Loss), Exchange Gain (Loss), or Remeasurement Gain (Loss). The title Remeasurement Gain (Loss) is used here because it is most descriptive of the item's source. The remeasurement gain or loss is included in the period's income because if the transactions had originally been recorded in U.S. dollars, the exchange gains and losses would have been recognized this period as part of the adjustments required for valuation of foreign transactions denominated in a foreign currency. Upon completion of the remeasurement process, the foreign entity's financial statements are presented as they would have been had the U.S. dollar been used to record the transactions in the local currency as they occurred.

Illustration of Remeasurement of a Foreign Subsidiary

German Company again is used, this time to present remeasurement of financial statements. The only difference between the previous example of translation and the current example is that the foreign subsidiary's functional currency is now assumed to be the U.S. dollar rather than the European euro. German Company maintains its books and records in euros to provide required reports to the German government. Because the dollar is the functional currency, German Company's financial statements will be remeasured into dollars. Once the foreign affiliate's statements are remeasured, the consolidation process is the same as for a domestic subsidiary.

Remeasurement of Foreign Subsidiary's Postacquisition Trial Balance

The subsidiary's trial balance must be remeasured from the European euro into the U.S. dollar as shown in Figure 12–10. The current exchange rate is used to remeasure the monetary accounts, and the appropriate historical exchange rates are used for each of the nonmonetary accounts.

Three items need special attention. First, the plant and equipment are remeasured using the historical rate on the date the parent company acquired the foreign subsidiary. If the subsidiary purchases any additional plant or equipment after the parent has acquired the subsidiary's stock, the additional plant or equipment will be remeasured using the

FIGURE 12–10
December 31, 20X1, Remeasurement of the Foreign Subsidiary's Trial Balance
U.S. Dollar Is the Functional Currency

Item	Balance, €	Exchange Rate	Balance, $
Cash	10,750	1.40	15,050
Foreign Currency Units	3,000	1.40	4,200
Receivables	10,500	1.40	14,700
Inventory	5,000	1.38	6,900
Plant & Equipment	50,000	1.20	60,000
Cost of Goods Sold	22,500	(*a*)	28,100
Operating Expenses	14,500	(*b*)	18,600
Foreign Currency Transaction Loss	500	1.30	650
Dividends Paid	6,250	1.36	8,500
Total Debits	123,000		156,700
Accumulated Depreciation	7,500	1.20	9,000
Accounts Payable	3,000	1.40	4,200
Bonds Payable	12,500	1.40	17,500
Common Stock	40,000	1.20	48,000
Retained Earnings	10,000	(*c*)	12,000
Sales	50,000	1.30	65,000
Total	123,000		155,700
Remeasurement Gain			1,000
Total Credits			156,700

	In Euros	Exchange Rate	In Dollars
(*a*) Cost of Goods Sold:			
Beginning Inventory	7,500	1.20	9,000
Purchases	20,000	1.30	26,000
Goods Available	27,500		35,000
Less: Ending Inventory	(5,000)	1.38	(6,900)
Cost of Goods Sold	22,500		28,100
(*b*) Operating Expenses:			
Cash Expenses	12,000	1.30	15,600
Depreciation Expense	2,500	1.20	3,000
	14,500		18,600

(*c*) Carry forward from January 1, 20X1, worksheet.

exchange rate on the date of the purchase of the additional plant. The same cautionary note is applicable to the other nonmonetary items. It is important to maintain a record of the subsidiary's acquisition or disposition of nonmonetary assets and equities after the foreign subsidiary's stock is acquired to ensure use of the proper exchange rates to remeasure these items. Recall that the business combination was accounted for as a purchase; therefore, the appropriate historical rate is the spot rate on the date the parent purchased the foreign subsidiary's stock.

Second, the cost of goods sold consists of transactions that occurred at various exchange rates. The beginning inventory was acquired when the rate was $1.20 = €1. Inventory purchases were made at different times during the year, so the average rate of $1.30 was used for the remeasurement exchange rate. For purposes of illustration, the example assumes that ending inventory was acquired when the direct exchange rate was $1.38 = €1 and the FIFO inventory method is used.

Third, the operating expenses are also incurred at different exchange rates. The depreciation expense is remeasured at $1.20 = €1 because it is associated with a nonmonetary account, Plant and Equipment, which is remeasured at the historical exchange rate of $1.20 = €1. The average exchange rate is used to remeasure the remaining operating expenses because they are assumed to be incurred evenly throughout the period.

FIGURE 12–11
Proof of the Remeasurement Exchange Gain for the Year Ended December 31, 20X1
Functional Currency Is the U.S. Dollar

Schedule 1
Statement of Net Monetary Positions

	End of Year	Beginning of Year
Monetary assets:		
Cash	€10,750	€ 2,500
Foreign currency units	3,000	0
Receivables	10,500	10,000
Total	€24,250	€12,500
Less: Monetary equities:		
Accounts payable	€ 3,000	€ 2,500
Bonds payable	12,500	12,500
Total	€15,500	€15,000
Net monetary liabilities		€ (2,500)
Net monetary assets	€ 8,750	
Increase in net monetary assets during year	€11,250	

Schedule 2
Analysis of Changes in Monetary Accounts

	€	Exchange Rate	U.S. $
Exposed net monetary liability position, 1/1	(2,500)	1.20	(3,000)
Adjustments for changes in net monetary position during year:			
Increases:			
From operations:			
Sales	50,000	1.30	65,000
From other sources	0		0
Decreases:			
From operations:			
Purchases	(20,000)	1.30	(26,000)
Cash expenses	(12,000)	1.30	(15,600)
Foreign currency transaction loss	(500)	1.30	(650)
From dividends	(6,250)	1.36	(8,500)
From other uses	0		0
Net monetary position prior to remeasurement at year-end rates			11,250
Exposed net monetary asset position, 12/31	8,750	1.40	12,250
Remeasurement gain			1,000

The remeasurement gain is recognized in this period's income statement. The remeasurement exchange gain is a balancing item to make total debits and total credits equal, but it can be proved by analyzing changes in the monetary items during the period.

Proof of Remeasurement Exchange Gain

Figure 12–11 provides a proof of this balancing item. The analysis primarily involves the monetary items because they are remeasured from the exchange rate at the beginning of the period or on the date of the generating transaction to the current exchange rate at the end of the period. The increase or decrease in net monetary assets resulting from remeasurement is recognized as an exchange gain or loss in the current period.

Schedule 1 presents the net monetary positions at the beginning and end of the year. The €11,250 change in the net monetary position is the change from a net liability opening balance of €2,500 to a net monetary asset position ending balance of €8,750. Schedule 2

presents the detailed effects of exchange rate changes on the foreign entity's net monetary position during this period. The beginning net monetary position is included using the exchange rate at the beginning of the year. Then all increases and decreases in the net monetary accounts are added or deducted using the exchange rates at the time the transactions occurred. Other sources of increases or decreases in the monetary accounts would include financing and investing transactions such as purchases of plant or equipment, issuance of long-term debt, or selling stock. The computed net monetary position at the end of the year using the transaction date exchange rates ($11,250) is then compared with the year-end net monetary position using the year-end exchange rate ($12,250). Because of the increasing exchange rate, the net asset position at the year-end was higher when remeasured using the December 31, 20X1, exchange rate of $1.40. This means that the U.S. dollar–equivalent value of the net monetary assets at year-end increased from $11,250 to $12,250 and that a remeasurement gain of $1,000 should be recognized. If the U.S. dollar–equivalent value of the December 31, 20X1, exposed net monetary assets position, as remeasured with the December 31 exchange rate, would have been lower than the computed value of $11,250, then a remeasurement loss would have been recognized for the reduction in the U.S. dollar–equivalent value of the net assets.

Remeasurement Case: Subsequent Consolidation Worksheet

LO 12-7

Prepare consolidated financial statements including a foreign subsidiary after remeasurement.

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Figure 12–12 presents the consolidation worksheet for the remeasurement case. The accounts used for German Company in the consolidation worksheet come from the remeasured accounts computed in Figure 12–10. The remeasurement gain is included in the German subsidiary's trial balance because the source of this account is the remeasurement of the subsidiary's accounts.

In the consolidated income statement, the Remeasurement Gain account is usually offset against the foreign currency transaction loss account, generating, in this example, a net gain of $350 ($1,000 − $650). This gain is reported in the other income section of the income statement. The remaining consolidation process is identical to the process for a domestic subsidiary. Note that the $2,400 patent shown on the consolidated balance sheet is the unamortized portion of the initial $3,000 amount ($2,400 = $3,000 − $600). No special adjustments are required for the patent when using the remeasurement process.

To prepare the elimination entries, we begin by analyzing the book value of the investment in German Company:

Book Value Calculations:

	Peerless 100%	=	Common Stock	+	Retained Earnings
Beginning book value	60,000		48,000		12,000
+ Net Income	18,650				18,650
− Dividends	(8,500)				(8,500)
Ending book value	70,150		48,000		22,150

This leads to the basic elimination entry:

Basic Elimination Entry:

Common stock	48,000		← Common stock balance
Retained earnings	12,000		← Beginning balance in retained earnings
Income from German Co.	18,650		← German Company's reported income
Dividends declared		8,500	← 100% of German's dividends declared
Investment in German Co.		70,150	← Net book value in investment account

The differential is entirely attributable to the patent, $3,000; nevertheless, because it arises from the acquisition of a foreign subsidiary, we provide the following

FIGURE 12–12 December 31, 20X1, Consolidation Worksheet, Prepared after Remeasurement of Foreign Statements

	Peerless Products	German Company	Elimination Entries DR	Elimination Entries CR	Consolidated
Income Statement					
Sales	400,000	65,000			465,000
Less: COGS	(170,000)	(28,100)			(198,100)
Less: Operating Expenses	(90,000)	(18,600)	600		(109,200)
Less: Foreign Currency Transaction Loss		(650)			(650)
Remeasurement Gain		1,000			1,000
Income from German Co.	18,050		18,650	600	0
Net Income	**158,050**	**18,650**	**19,250**	**600**	**158,050**
Statement of Retained Earnings					
Beginning Balance	300,000	12,000	12,000		300,000
Net Income	**158,050**	**18,650**	**19,250**	**600**	**158,050**
Less: Dividends Declared	(60,000)	(8,500)		8,500	(60,000)
Ending Balance	**398,050**	**22,150**	**31,250**	**9,100**	**398,050**
Balance Sheet					
Cash	425,500	15,050			440,550
Dollars Held by German Company		4,200			4,200
Receivables	75,000	14,700			89,700
Inventory	100,000	6,900			106,900
Investment in German Company Stock	72,550			70,150	0
				2,400	
Land	175,000				175,000
Patent			2,400		2,400
Plant & Equipment	800,000	60,000		6,000	854,000
Less: Accumulated Depreciation	(450,000)	(9,000)	6,000		(453,000)
Total Assets	**1,198,050**	**91,850**	**8,400**	**78,550**	**1,219,750**
Accounts Payable	100,000	4,200			104,200
Bonds Payable	200,000	17,500			217,500
Common Stock	500,000	48,000	48,000		500,000
Retained Earnings	**398,050**	**22,150**	**31,250**	**9,100**	**398,050**
Total Liabilities & Equity	**1,198,050**	**91,850**	**79,250**	**9,100**	**1,219,750**

calculations to illustrate the translation adjustment for the differential (amortized over a five-year period):

Excess Value (differential) Calculations:

	Total Excess	=	Patent
Beginning excess value	**3,000**		**3,000**
– Amortization of differential ($3,000/5 years)	**600**		**600**
Ending excess value	**2,400**		**2,400**

Amortized Excess Value Reclassification Entry:

Operating expense	**600**		← Amortization of patent
Income from German Co.		**600**	← Elimination of patent amortization

Excess Value (differential) Reclassification Entry:

Patent	**2,400**		← Excess value assigned to patent
Investment in German Co.		**2,400**	← Reclassify excess acquisition price

Finally, we include the optional accumulated depreciation elimination entry:

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	**6,000**	
Building and equipment		**6,000**

← Accumulated depreciation at the time of the acquisition netted against cost

A comparison of Figures 12–7 and 12–12 shows that the foreign subsidiary's reported income between translation and remeasurement differs. The primary reason that the subsidiary's reported income is approximately 15 percent higher when the dollar is the functional currency ($18,650 versus $16,250 under translation) is that the U.S. dollar weakened against the European euro during the year. This results in a remeasurement gain for the subsidiary because it was transacting in the stronger currency (the euro) during the period. Furthermore, the subsidiary's cost of goods sold and operating expenses also are remeasured at a lower exchange rate, resulting in a higher income.

The following T-accounts illustrate the calculation of the ending balances for Peerless' Investment in German Company and Income from German Company accounts and how the worksheet entries eliminate their balances:

Investment in German Company			Income from German Company		
Acquisition 1/1/X1	**63,000**				
100% Net Income	**18,650**			**18,650**	**100% Net Income**
	8,500	**Dividends**			
	600	**Excess Price Amortization**	**600**		
Balance 12/31/X1	**72,550**			**18,050**	**Balance 12/31/X1**
	70,150	**Basic**	**18,650**		
	2,400	**Excess Reclass.**		**600**	**Excess Value Reclass.**
	0			**0**	

Summary of Translation versus Remeasurement

When the functional currency is the dollar, the nonmonetary items on the balance sheet are remeasured using historical exchange rates. In this example, the direct exchange rate has increased during the period; therefore, the nonmonetary accounts are lower when remeasured than when translated. See Figure 12–13 for a summary of the differences between the translation and remeasurement methods.

ADDITIONAL CONSIDERATIONS IN ACCOUNTING FOR FOREIGN OPERATIONS AND ENTITIES

LO 12-8

Understand other issues related to foreign operations including hedging of a net investment in a foreign subsidiary.

This section covers special topics in accounting for multinational enterprises. Although many of these additional considerations are very technical, study of this section will complement your understanding of the many issues of accounting for foreign entities. For example, Figure 12–14 illustrates the two-statement approach to display comprehensive income.

FOREIGN INVESTMENTS AND UNCONSOLIDATED SUBSIDIARIES

Most companies consolidate their foreign subsidiaries in conformity with **ASC 810 and ASC 840**. In some cases, these operations are not consolidated because of criteria that apply to foreign subsidiaries. Generally, a parent company consolidates a foreign subsidiary

FIGURE 12–13 Summary of the Translation and Remeasurement Processes

Item	Translation Process	Remeasurement Process
Foreign entity's functional currency	Local currency unit	U.S. dollar
Method used	Current rate method	Monetary-nonmonetary method
Income statement accounts:		
Revenue	Weighted-average exchange rate	Weighted-average exchange rate except revenue related to nonmonetary items (historical exchange rate)
Expenses	Weighted-average exchange rate	Weighted-average exchange rate except costs related to nonmonetary items (historical exchange rate)
Balance sheet accounts:		
Monetary accounts	Current exchange rate	Current exchange rate
Nonmonetary accounts	Current exchange rate	Historical exchange rate
Stockholders' equity capital accounts	Historical exchange rate	Historical exchange rate
Retained earnings	Prior-period balance plus income less dividends	Prior-period balance plus income less dividends
Exchange rate adjustments arising in process	Translation adjustment accumulated in stockholders' equity	Remeasurement gain or loss included in period's income statement

FIGURE 12–14 Two-Statement Approach to Display Comprehensive Income

PEERLESS PRODUCTS AND SUBSIDIARY
Consolidated Income Statement
Year Ended December 31, 20X1

Sales	$465,000
Cost of Goods Sold	(199,250)
Gross Profit	265,750
Operating Expenses	(109,500)
Foreign Currency Transaction Loss	(650)
Consolidated Net Income to Controlling Interest	$155,600

PEERLESS PRODUCTS AND SUBSIDIARY
Consolidated Statement of Comprehensive Income
Year Ended December 31, 20X1

Consolidated Net Income to Controlling Interest	$155,600
Other Comprehensive Income: Foreign Currency Translation Adjustment	$ 11,450
Comprehensive Income to Controlling Interest	$167,050

except when one of the following conditions becomes so severe that the U.S. company owning a foreign company may not be able to exercise the necessary level of economic control over the foreign subsidiary's resources and financial operations to warrant consolidation:

1. Restrictions on foreign exchange in the foreign country.
2. Restrictions on transfers of property in the foreign country.
3. Other governmentally imposed uncertainties.

An unconsolidated foreign subsidiary is reported as an investment on the U.S. parent company's balance sheet. The U.S. investor company must use the equity method if it has the ability to exercise "significant influence" over the investee's financial and operating policies. If the equity method cannot be applied, the cost method is used to account for the foreign investment, recognizing income only as dividends are received.

When the equity method is used for an unconsolidated foreign subsidiary, the investee's financial statements are either remeasured or translated, depending on the determination of the functional currency. If remeasurement is used, the foreign entity's statements are

remeasured in dollars and the investor records its percentage of the investee's income and makes necessary amortizations or impairments of any differential. A shortcut approach is available for translation: Multiply the foreign affiliate's net income measured in foreign currency units by the average exchange rate during the period and then recognize the parent company's percentage share of the translated net income. In addition, the investor must recognize its share of the translation adjustment arising from the translation of the foreign entity's financial statements. The investor's share of the translation adjustment from its foreign investees is reported on the investor's balance sheet as a separate component of stockholders' equity and as an adjustment of the carrying value of the investment account. The entries on the investor's books are the same under the equity method whether the subsidiary is consolidated or reported as an unconsolidated investment.

Liquidation of a Foreign Investment

The translation adjustment account is directly related to a company's investment in a foreign entity. If the investor sells a substantial portion of its stock investment, **ASC 830** requires that the pro rata portion of the accumulated translation adjustment account attributable to that investment be included in computing the gain or loss on the disposition of the investment. For example, if the parent company sold 30 percent of its investment in a foreign subsidiary, 30 percent of the related cumulative translation adjustment would be removed from the translation adjustment account and included in determining the gain or loss on the disposition of the foreign investment.

HEDGE OF A NET INVESTMENT IN A FOREIGN SUBSIDIARY

ASC 815 permits the hedging of a net investment in foreign subsidiaries. For example, Peerless has a net investment of €50,000 in its German subsidiary for which it paid $66,000. Peerless could decide to hedge all, some, or none of this investment by accepting a liability in euros. Peerless could hedge its net asset investment by contracting for a forward exchange contract to sell euros, or the company could incur a euro-based liability. **ASC 815** states that the gain or loss on the effective portion of a hedge of a net investment is taken to other comprehensive income as part of the translation adjustment. However, the amount of offset to comprehensive income is limited to the translation adjustment for the net investment. For example, if the forward exchange rate is used to measure effectiveness, the amount of offset is limited to the change in spot rates during the period. Any excess on the ineffective portion of the hedge must be recognized currently in earnings.

For example, on January 1, 20X1, Peerless decides to hedge the portion of its investment that it just made in German Company that is related to the book value of German Company's net assets. Peerless is unsure whether the direct exchange rate for euros will increase or decrease for the year and wishes to hedge its net asset investment. On January 1, 20X1, Peerless' 100 percent ownership share of German Company's net assets is equal to €50,000 (€40,000 capital stock plus €10,000 retained earnings). Peerless borrows €50,000 at a 5 percent rate of interest to hedge its equity investment in German Company, and the principal and interest are due and payable on January 1, 20X2.

The entries on Peerless' books to account for this hedge of a net investment follow:

January 1, 20X1

(11)	Cash	60,000	
	Loan Payable (€)		60,000

Borrow a euro-denominated loan to hedge net investment in German subsidiary: $60,000 = €50,000 × $1.20 spot rate.

December 31, 20X1

(12)	Other Comprehensive Income	10,000	
	Loan Payable (€)		10,000

Revalue foreign currency–denominated payable to end-of-period spot rate: $10,000 = €50,000 × ($1.40 − $1.20).

(13)	Interest Expense	3,250	
	Foreign Currency Transaction Loss	250	
	Interest Payable (€)		3,500

Accrue interest expense and payable on euro loan:
$3,250 = €50,000 × 0.05 interest × $1.30 average exchange rate
$3,500 = €50,000 × 0.05 interest × $1.40 ending spot rate.

(14)	Accumulated OCI—Translation Adjustment	10,000	
	Profit and Loss Summary (or Retained Earnings)	250	
	Foreign Currency Transaction Loss		250
	Other Comprehensive Income		10,000

Close nominal accounts related to hedge of net investment in foreign subsidiary.

Then, when the principal and interest are paid on January 1, 20X2, Peerless makes the following entry:

January 1, 20X2

(15)	Interest Payable (€)	3,500	
	Loan Payable (€)	70,000	
	Cash		73,500

Pay principal and interest due on euro-denominated hedge:
$70,000 = $60,000 + $10,000.

During 20X1, Peerless hedged a portion of its net asset investment in the foreign subsidiary. The dollar weakened against the euro (the direct exchange rate increased) and Peerless recognized a gain on a net asset investment in euros and a loss on a liability payable in euros. Without this hedge of the net investment, Peerless would have reported a $11,450 credit balance in the cumulative translation portion of accumulated other comprehensive income ($11,450 = $11,000 + $450 differential adjustment). With the hedge of its net investment, Peerless will report just $1,450 ($11,450 − $10,000 effect of hedge) as its change in the cumulative translation adjustment for 20X1. Thus, Peerless has balanced a portion of its net exposure on its January 1, 20X1, net asset investment in German Company.

Note also that the amount of the offset to other comprehensive income is limited to the effective portion of the hedge based on the revaluation of the net assets. Any excess, in this case the $250 loss on the revaluation of the interest payable in entry (14), is taken directly to current earnings on the income statement.

DISCLOSURE REQUIREMENTS

ASC 830 requires the aggregate foreign transaction gain or loss included in income to be separately disclosed in the income statement or in an accompanying note. This includes gains or losses recognized from foreign currency transactions, forward exchange contracts, and any remeasurement gain or loss. If not disclosed as a one-line item on the income statement, this disclosure is usually a one-sentence footnote summarizing the company's foreign operations.

Under the translation method, the periodic change in the translation adjustment is reported as an element of other comprehensive income as required by **ASC 220.** Figure 12–14 presents the two-statement approach to displaying comprehensive income. The consolidated statement of comprehensive income presents the detail of the parent's other comprehensive income of $11,450. Review Figure 12–8 for the statement of changes in equity that reconciles all of the elements of stockholders' equity. The balance sheet would then display the capital stock, retained earnings, and accumulated other comprehensive income in the stockholders' equity section. In addition, **ASC 830** requires footnote disclosure of exchange rate changes that occur after the balance sheet date and their effect on unsettled foreign currency transactions, if significant.

Statement of Cash Flows

The statement of cash flows is a link between two balance sheets. Individual companies have some latitude and flexibility in preparing the statement of cash flows. A general rule is that accounts reported in the statement of cash flows should be restated in U.S. dollars using the same rates as used for balance sheet and income statement purposes. Because the average exchange rate is used in the income statement and the ending spot exchange rate (current rate) is used in the balance sheet, a balancing item for the differences in exchange rates appears in the statement of cash flows. This balancing item can be analyzed and traced to the specific accounts that generate the difference, but it does not affect the net change in the cash flow for the period.

Lower-of-Cost-or-Market Inventory Valuation under Remeasurement

The application of the lower-of-cost-or-market rule to inventories requires special treatment when the recording currency is not the entity's functional currency and, therefore, the foreign entity's financial statements must be remeasured into the functional currency. The historical cost of inventories must first be remeasured using historical exchange rates to determine the functional currency historical cost value. Then these remeasured costs are compared with the market value of the inventories translated using the current rate. The final step is to compare the cost and market, now both in the functional currency, and to recognize any appropriate write-downs to market. The comparison is made in functional currency values, not local or recording currency values; therefore, it is possible to have a write-down appear in the functional currency statements but not on the subsidiary's books, or on the subsidiary's books but not in the consolidated statements.

To illustrate the application of the lower-of-cost-or-market method, assume that a German subsidiary acquired €5,000 of inventory when the direct exchange rate was $1.38 = €1. At the end of the year, the direct exchange rate had decreased to $1.20 = €1. The estimated net realizable value of the inventory (ceiling) is €5,500; its replacement cost is €5,000; and the net realizable value less a normal profit margin (floor) is €4,000. The inventory valuation is first specified in the local currency unit (euro) and then evaluated after remeasurement into its functional currency, the U.S. dollar, using the end-of-period exchange rate, as follows:

	€	Exchange	U.S. $
Historical cost	5,000	$1.38	6,900
Net realizable value (ceiling)	5,500	$1.20	6,600
Replacement cost	5,000	1.20	6,000
Net realizable value less normal profit (floor)	4,000	1.20	4,800

The market value of the inventory is €5,000, or $6,000. Note that the subsidiary recorded no write-down because the inventory's historical cost was the same as market. However, the comparison in functional currency (U.S. dollar) values shows that the U.S. parent requires a $900 write-down to write the inventory down from its functional currency historical cost of $6,900 to its functional currency market value of $6,000.

Intercompany Transactions

A U.S. parent or home office may have many intercompany sales or purchases transactions with its foreign affiliate that create intercompany receivables or payables. The process of translating receivables or payables denominated in a foreign currency was discussed in Chapter 11. For example, assume that a U.S. company has a foreign currency–denominated receivable from its foreign subsidiary. The U.S. company would first revalue the foreign currency–denominated receivable to its U.S. dollar–equivalent

value as of the date of the financial statements. After the foreign affiliate's statements have been translated or remeasured, depending on the foreign affiliate's functional currency, the intercompany payable and receivable should be at the same U.S. dollar value and can be eliminated.

ASC 830 provides an exception when the intercompany foreign currency transactions will not be settled within the foreseeable future. These intercompany transactions may be considered part of the net investment in the foreign entity. The translation adjustments on these long-term receivables or payables are deferred and accumulated as part of the cumulative translation account. For example, a U.S. parent company may loan its German subsidiary $10,000 for which the parent does not expect repayment for the foreseeable future. Under the translation method, the subsidiary's dollar-denominated loan payable account would first be adjusted for the effects of any changes in exchange rates during the period. Any exchange gain or loss adjustment relating to this intercompany note should be classified as part of the cumulative translation adjustment account in stockholders' equity, not in the subsidiary's net income for the period. The same result would occur whether the long-term intercompany financing was denominated in U.S. dollars or the local currency—in our example, the euro. Thus, when financing is regarded as part of the long-term investment in the foreign entity, any exchange gain or loss adjustments on that financing are accumulated in the cumulative translation adjustment account in stockholders' equity.

A particularly interesting problem arises when unrealized intercompany profits occur from transactions between the parent and foreign subsidiary. The problem is how to eliminate the profit across currencies that are changing in value relative to each other. For example, assume that the parent, Peerless Products Corporation, made a downstream sale of inventory to its German subsidiary. The goods cost the parent $10,000 but were sold to the subsidiary for €10,000 when the exchange rate was $1.30 = €1, resulting in an intercompany profit of $3,000 ($13,000 − $10,000). The goods are still in the subsidiary's inventory at the end of the year when the current exchange rate is $1.40 = €1. The relevant facts are summarized as follows:

	Measured in U.S. Dollars	Measured in European Euros
Initial inventory transfer date ($1.30 = €1):		
Selling price (€10,000 × $1.30)	13,000	10,000
Cost to parent	(10,000)	
Intercompany profit	3,000	
Balance sheet date ($1.40 = €1):		
Inventory translation ($14,000 = €10,000 × $1.40)	14,000	10,000

There are two issues here:

1. At what amount should the ending inventory be shown on the consolidated balance sheet—the original intercompany transfer price of $13,000 (€10,000 × $1.30), the present equivalent exchange value of $14,000 (€10,000 × $1.40 current exchange rate), or some other amount?
2. What amount should be eliminated for the unrealized intercompany gain—the original intercompany profit of $3,000 or the balance sheet date exchange equivalent of the intercompany profit of $4,000 ($14,000 present exchange value less $10,000 original cost to parent)?

ASC 830 provides the following guidance to answer these questions **(ASC 830-30-45-10)**:

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

Therefore, for the example, the elimination entry for the intercompany profit is

Cost of Goods Sold	**3,000**	
Ending Inventory		**3,000**

The inventory is shown on the consolidated balance sheet at $11,000, which is a $1,000 increase over the initial cost to the parent company. This increase will result in a corresponding increase in a credit to the translation adjustment component of stockholders' equity. The FASB has stated that changes in exchange rates occurring *after* the date of the intercompany transaction are independent of the initial inventory transfer.

Income Taxes

Interperiod tax allocation is required whenever temporary differences exist in the recognition of revenue and expenses for income statement purposes and for tax purposes. Exchange gains and losses from foreign currency transactions require the recognition of a deferred tax if they are included in income but not recognized for tax purposes in the same period.

A deferral is required for the portion of the translation adjustment related to the subsidiary's undistributed earnings that are included in the parent's income. **ASC 740** presumes that a temporary difference exists for undistributed earnings of a subsidiary unless the earnings are indefinitely reinvested in it. Deferred taxes need not be recognized if the undistributed earnings will be indefinitely reinvested in the subsidiary. However, if the parent expects eventually to receive the presently undistributed earnings of a foreign subsidiary, deferred tax recognition is required, and the tax entry recorded by the parent should include a debit to Other Comprehensive Income rather than to additional income tax, as follows:

(16)	Other Comprehensive Income—Translation Adjustment	X,XXX	
	Deferred Taxes Payable		X,XXX

Translation When a Third Currency Is the Functional Currency

In a few cases, the foreign subsidiary maintains its books and records in the local currency unit but has a third currency as its functional currency. For example, assume that our subsidiary, German Company, maintains its records in its local currency, the euro. If the subsidiary conducts many of its business activities in the Swiss franc, management may conclude that the Swiss franc is the subsidiary's functional currency. If the entity's books and records are *not* expressed in its functional currency, the following two-step process must be used:

1. Remeasure the subsidiary's financial statements into the functional currency. In our example, the financial statements expressed in euros would be remeasured into Swiss francs. The remeasurement process would be the same as illustrated earlier in the chapter. The statements would now be expressed in the entity's functional currency, the Swiss franc.
2. The statements expressed in Swiss francs are then translated into U.S. dollars using the translation process illustrated in the chapter.

As indicated, this occurrence is not common in practice but is a consideration for foreign subsidiaries that have very significant business activities in a currency other than the currency of the country in which the subsidiary is physically located. This discussion indicates that it is important first to determine the foreign entity's functional currency before beginning the translation process.

Summary of Key Concepts

The restatement of a foreign affiliate's financial statements in U.S. dollars may be made using the translation or remeasurement method, depending on the foreign entity's functional currency. Most foreign affiliates' statements are translated using the current rate method because the local currency unit is typically the functional currency. If the U.S. dollar is the functional currency, remeasurement is used to convert the foreign entity's statements from the local currency into dollars. The choice of functional currency affects the valuations of the foreign entity's accounts reported on the consolidated financial statements.

Because translation or remeasurement is performed with different exchange rates applied to balance sheet and income statement accounts, a balancing item called a "translation adjustment" or "remeasurement gain or loss" is created in the process. The translation adjustment is proportionally divided between the parent company and the noncontrolling interest. The parent company's share, adjusted for the effects from the differential paid for the investment, is reported as a component of other comprehensive income and then accumulated in the stockholders' equity section of the consolidated balance sheet. The noncontrolling interest's share is a direct adjustment to noncontrolling interest reported in the consolidated balance sheet. The remeasurement gain or loss is reported in the consolidated income statement.

Key Terms

accumulated other comprehensive income, *623*
average rate, *617*
comprehensive income, *623*
current rate, *617*
current rate method, *620*
functional currency, *617*
historical rate, *617*
International Financial Reporting Standards (IFRS), *614*
local currency unit, *616*
other comprehensive income, *623*
recording currency, *617*
remeasurement, *619*
remeasurement gain or loss, *635*
reporting currency, *617*
temporal method, *620*
translation, *619*
translation adjustment, *617, 622*

Questions

LO 12-1 **Q12-1** Why is there increasing interest in the adoption of a single set of high-quality accounting standards?

LO 12-1 **Q12-2** Briefly discuss the International Accounting Standards Board (IASB). What is its mission? What is the composition of its membership and how long do members serve? Where is the IASB located?

LO 12-1 **Q12-3** The IASB promulgates International Financial Reporting Standards (IFRS). Briefly describe the standard-setting process used by the IASB.

LO 12-1 **Q12-4** How widely used are IFRS? Can IFRS be used for listings on U.S. stock exchanges?

LO 12-1 **Q12-5** What is the attitude toward the possible use of IFRS in the United States?

LO 12-1 **Q12-6** What potential benefits might be achieved if U.S. firms are allowed to use IFRS?

LO 12-2 **Q12-7** Define the following terms: (*a*) *local currency unit,* (*b*) *recording currency,* and (*c*) *reporting currency.*

LO 12-2 **Q12-8** What factors are used to determine a reporting entity's functional currency? Provide at least one example for which a company's local currency may not be its functional currency.

LO 12-1 **Q12-9** Some accountants are seeking to harmonize international accounting standards. What is meant by the term *harmonize?* How might harmonization result in better financial reporting for a U.S. parent company with many foreign investments?

LO 12-3 **Q12-10** A Canadian-based subsidiary of a U.S. parent uses the Canadian dollar as its functional currency. Describe the methodology for translating the subsidiary's financial statements into the parent's reporting currency.

LO 12-3 **Q12-11** A U.S. company has a foreign sales branch located in Spain. The Spanish branch has selected the U.S. dollar for its functional currency. Describe the methodology for remeasuring the branch's financial statements into the U.S. company's reporting currency.

LO 12-4, 12-5 **Q12-12** Discuss the accounting treatment and disclosure of translation adjustments. When does the translation adjustment account have a debit balance? When does it have a credit balance?

LO 12-6 **Q12-13** Where is the remeasurement gain or loss shown in the consolidated financial statements?

LO 12-4 **Q12-14** When the functional currency is the foreign affiliate's local currency, why are the stockholders' equity accounts translated at historical exchange rates? How is retained earnings computed?

LO 12-4 **Q12-15** Comment on the following statement: "The use of the current exchange rate method of translating a foreign affiliate's financial statements allows for an assessment of foreign management by the same ratio criteria used to manage the foreign affiliate."

LO 12-5 **Q12-16** A U.S. company paid more than book value in acquiring a foreign affiliate. How is this excess reported in the consolidated balance sheet and income statement in subsequent periods when the functional currency is the local currency unit of the foreign affiliate?

LO 12-5 **Q12-17** What is the logic behind the parent company's recognizing on its books its share of the translation adjustment arising from the translation of its foreign subsidiary?

LO 12-8 **Q12-18** Are all foreign subsidiaries consolidated? Why or why not?

LO 12-8 **Q12-19** Describe the accounting for a foreign investment that is not consolidated with the U.S. company.

LO 12-8 **Q12-20** Describe the basic problem of eliminating intercompany transactions with a foreign affiliate.

Cases

LO 12-1 **C12-1** **Comparison of U.S. GAAP and IFRS**

Research

PricewaterhouseCoopers offers a publication on its website entitled "IFRS and US GAAP: Similarities and Differences that provides a topic-based comparison. Access this publication on the Web at http://www.pwc.com/us/en/issues/ifrs-reporting/publications/ifrs-and-us-gaap-similarities-and-differences.jhtml. On page 17 of this publication, there is a table of contents by reporting issue. Select any three of the items and read about the nature of the differences. Prepare a short paper approximately 2–3 pages long that defines the nature of the differences and discusses what you have found.

LO 12-1 **C12-2** **Structure of the IASB**

Research

The IASB website can be found at www.ifrs.org. At the top of the page, click on the link "About Us." Briefly describe the structure of the IASB.

LO 12-1 **C12-3** **IASB Deliberations**

Research

The IASB website can be found at www.ifrs.org. Access the website and click on the link at the top of the page for Standards development/Work plan for IFRSs. You may also access this page by going directly to http://www.ifrs.org/Current+Projects/IASB+Projects/IASB+Work+Plan.htm. What are three projects currently on the active agenda that are being addressed by the IASB? What is the timetable identified for milestones on each of the projects? What is the status of the Conceptual Framework project?

LO 12-2 **C12-4** **Determining a Functional Currency**

Following are descriptions of several independent situations.

Judgment

1. Rockford Company has a subsidiary in Argentina. The subsidiary does not have much debt because of the high interest costs resulting from the average annual inflation rate exceeding 100 percent. Most of its sales and expense transactions are denominated in Argentinean pesos, and the subsidiary attempts to minimize its receivables and payables. Although the subsidiary owns a warehouse, the primary asset is inventory that it receives from Rockford. The Argentinean government requires all companies located in Argentina to provide the central government with a financial report using the Argentinean system of accounts and government-mandated forms for financial statements.
2. JRB International, located in Dallas, Texas, is the world's largest manufacturer of electronic stirrups. The company acquires the raw materials for its products from around the world and begins the assembly process in Dallas. It then sends the partially completed units to its subsidiary in Mexico for assembly completion. Mexico has been able to hold its inflation rate under 100 percent over the last three years. The subsidiary is required to pay its employees and local vendors in Mexican pesos. The parent company provides all financing for the Mexican subsidiary, and the subsidiary sends all of its production back to the warehouse in Dallas, from which it is shipped as orders are received. The subsidiary provides the Mexican government with financial statements.

3. Huskie Inc. maintains a branch office in Great Britain. The branch office is fairly autonomous because it must find its own financing, set its own local marketing policies, and control its own costs. The branch receives weekly shipments from Huskie Inc., which it then conveys to its customers. The pound sterling is used to pay the subsidiary's employees and to pay for the weekly shipments.
4. Hola Company has a foreign subsidiary located in a rural area of Switzerland, right next to the Swiss–French border. The subsidiary hires virtually all its employees from France and makes most of its sales to companies in France. The majority of its cash transactions are maintained in the European euro. However, it is required to pay local property taxes and sales taxes in Swiss francs and to provide annual financial statements to the Swiss government.

Required

For each of these independent cases, determine

a. The foreign entity's recording currency in which its books and records are maintained.
b. The foreign entity's functional currency.
c. The process to be used to restate the foreign entity's financial statements into the reporting currency of the U.S.-based parent company.

LO 12-4, 12-5, 12-8

C12-5 Principles of Consolidating and Translating Foreign Accounts [AICPA Adapted]

Understanding

Petie Products Company was incorporated in Wisconsin in 20X0 as a manufacturer of dairy supplies and equipment. Since incorporating, Petie has doubled in size about every three years and is now considered one of the leading dairy supply companies in the country.

During January 20X4, Petie established a subsidiary, Cream Ltd., in the emerging nation of Kolay. Petie owns 90 percent of Cream's outstanding capital stock; Kolay citizens hold the remaining 10 percent of Cream's outstanding capital stock as Kolay law requires. The investment in Cream, accounted for by Petie using the equity method, represents about 18 percent of Petie's total assets at December 31, 20X7, the close of the accounting period for both companies.

Required

a. What criteria should Petie use in determining whether it would be appropriate to prepare consolidated financial statements with Cream Ltd. for the year ended December 31, 20X7? Explain.
b. Independent of your answer to part *a,* assume it has been appropriate for Petie and Cream to prepare consolidated financial statements for each year, 20X4 through 20X7. Before they can be prepared, the individual account balances in Cream's December 31, 20X7, adjusted trial balance must be translated into dollars. The kola (K) is the subsidiary's functional currency. For each of the following 10 accounts taken from Cream's adjusted trial balance, specify what exchange rate (e.g., average exchange rate for 20X7, current exchange rate on December 31, 20X7) should be used to translate the account balance into dollars and explain why that rate is appropriate. Number your answers to correspond with these accounts.

(1) Cash in Kolay National Bank.
(2) Trade Accounts Receivable (all from 20X7 revenue).
(3) Supplies Inventory (all purchased during the last quarter of 20X7).
(4) Land purchased in 20X4.
(5) Short-term note payable to Kolay National Bank.
(6) Capital Stock (no par or stated value and all issued in January 20X4).
(7) Retained Earnings, January 1, 20X7.
(8) Sales Revenue.
(9) Depreciation Expense (on buildings).
(10) Salaries Expense.

LO 12-2, 12-4, 12-5, 12-6

C12-6 Translating and Remeasuring Financial Statements of Foreign Subsidiaries [AICPA Adapted]

Communication

Wahl Company's 20X5 consolidated financial statements include two wholly owned subsidiaries, Wahl Company of Australia (Wahl A) and Wahl Company of France (Wahl F). Functional currencies are the U.S. dollar for Wahl A and the European euro for Wahl F.

Required

a. What are the objectives of translating a foreign subsidiary's financial statements?

b. How are gains and losses arising from the translation or remeasurement of each subsidiary's financial statements measured and reported in Wahl's consolidated financial statements?

c. **ASC 830** identifies several economic indicators to be considered both individually and collectively in determining the functional currency for a consolidated subsidiary. List three of these indicators.

d. What exchange rate is used to incorporate each subsidiary's equipment cost, accumulated depreciation, and depreciation expense in Wahl's consolidated financial statements?

LO 12-5

C12-7 Translation Adjustment and Comprehensive Income

Analysis

Dundee Company owns 100 percent of a subsidiary located in Ireland. The parent company uses the Euro as the subsidiary's functional currency. At the beginning of the year, the debit balance in the Accumulated Other Comprehensive Income—Translation Adjustment account, which was the only item in accumulated other comprehensive income, was $80,000. The subsidiary's translated trial balance at the end of the year is as follows:

	Debit	Credit
Cash	$ 50,000	
Receivables	24,700	
Inventories	60,300	
Property, Plant, & Equipment (net)	328,000	
Cost of Sales	285,000	
Operating Expenses (including depreciation)	140,000	
Dividends	12,000	
Current Payables		$ 16,000
Long-Term Payables		181,000
Capital Stock		100,000
Retained Earnings (1/1 balance)		135,000
Sales		560,000
Accumulated Other Comprehensive Income—Translation Adjustment	92,000	
	$992,000	$992,000

Required

a. Prepare the subsidiary's income statement, ending in net income, for the year.

b. Prepare the subsidiary's statement of comprehensive income for the year.

c. Prepare a year-end balance sheet for the subsidiary.

d. **ASC 220** allows for alternative operating statement displays of the other comprehensive income items. Discuss the major differences between the one-statement format of the income statement and comprehensive income versus the two-statement format of the income statement with a separate statement of comprehensive income.

LO 12-5

C12-8 Changes in the Cumulative Translation Adjustment Account

Understanding

The following footnote was abstracted from a recent annual report of Johnson & Johnson Company:

> Footnote 7: Foreign Currency Translation
> For translation of its international currencies, the Company has determined that the local currencies of its international subsidiaries are the functional currencies except those in highly inflationary economies, which are defined as those which have had compound cumulative rates of inflation of 100% or more during the last three years.
>
> In consolidating international subsidiaries, balance sheet currency effects are recorded as a separate component of stockholders' equity. This equity account includes the results of translating all balance sheet assets and liabilities at current exchange rates, except those located in highly inflationary economies, principally Brazil, which are reflected in operating results. These translation adjustments do not exist in terms of functional cash flows; such adjustments are not reported as part of operating results since realization is remote unless the international businesses were sold or liquidated.

An analysis of the changes during 20X3 and 20X2 in the separate component of stockholders' equity for foreign currency translation adjustments follows (with debit amounts in parentheses):

(Dollars in Millions)	20X3	20X2
Balance at beginning of year	$(146)	$ 134
Change in translation adjustments	(192)	(280)
Balance at end of year	$(338)	$(146)

Required

a. What is the main point of the footnote?

b. How is the footnote related to the concepts covered in the chapter?

c. List some possible reasons the company's translation adjustment decreased from a $134 million credit balance at the end of 20X1 to a $338 million debit balance at the end of 20X3.

d. Assume that the translated stockholders' equities of the foreign subsidiaries, other than the cumulative translation adjustment, remained constant from 20X1 through 20X3 at a balance of $500 million. What were the translated balances in the net assets (assets minus liabilities) of the foreign subsidiaries in each of the three years? What factors might cause the changes in the balances of the net assets over the three-year period?

e. How would changes in the local currency unit's exchange rate in the countries in which the company has subsidiaries affect the cumulative translation adjustment?

f. How could you verify the actual causal factors for the changes in the cumulative translation adjustment of Johnson & Johnson Company for the years presented? Be specific!

LO 12-8

C12-9 Pros and Cons of Foreign Investment

Judgment

Many larger U.S. companies have significant investments in foreign operations. For example, McDonald's Corporation, the food service company, obtains 47 percent of its consolidated revenues and 44 percent of its operating income from, and has 45 percent of its invested assets in, non-U.S. locations. Unisys, the information systems company, obtains 51 percent of its consolidated revenues and 65 percent of its operating income from, and has 40 percent of its invested assets in, non-U.S. locations. Foreign operations impose additional types of operating risks to companies, including the risks from changes in the exchange rates for currencies, statutory acts by the foreign governments, and producing and marketing goods in an environment outside the United States.

With the passage of the North American Free Trade Agreement (NAFTA), more companies are confronted with the decision of whether or not to expand their production and marketing investments to Canada and Mexico.

Required

Using NAFTA as a discussion focus, address the following questions:

a. Explain why a U.S. company might find it advantageous to increase its production capacity of its subsidiaries in Mexico. Describe some circumstances under which it would be disadvantageous for a U.S. company to increase its investment in production subsidiaries located in Mexico.

b. In your opinion, would an increase in U.S. companies' investments in Mexico and Canada be good or bad for U.S. consumers?

c. What are some possible solutions to the possible problem of an increase in the U.S. unemployment rate if U.S. companies shift their production facilities to non-U.S. locations? Select one and discuss the pros and cons of that possible solution.

d. What conclusion can you draw from the attempts of the U.S. government to decrease barriers to international trade and investment? In your opinion, is this a good effort on the part of the government, or do you feel this effort should be changed?

LO 12-2

C12-10 Determining an Entity's Functional Currency

Research

Maxima Corporation, a U.S. company, manufactures lighting fixtures and ceiling fans. Eight years ago, it set up a subsidiary in Mexico to manufacture three of its most popular ceiling fan models. When the subsidiary, Luz Maxima, was set up, it did business exclusively with Maxima, receiving shipments of

materials from U.S. suppliers selected by Maxima and selling all of its production to Maxima. Maxima's management made a determination that its subsidiary's functional currency was the U.S. dollar.

During the past five years, changes in Luz Maxima's operations have occurred. The subsidiary has developed relationships with suppliers within Mexico and is obtaining a significant percentage of its materials requirements from these suppliers. In addition, Luz Maxima has expanded its production by introducing a new product line marketed within Mexico and Central America. These products now make up a substantial percentage of the subsidiary's sales. Luz Maxima obtained long-term debt financing and a line of credit from several Mexican banks to expand its operations.

Prior to the preparation of Maxima's consolidated financial statements for the current year, Luz Maxima's financial statements, reported in Mexican pesos, had to be converted into U.S. dollars. Maxima's CFO, Garry Parise, is concerned that Luz Maxima's functional currency may no longer be the U.S. dollar and that remeasurement of its financial statements may not be appropriate.

Required

Research the most current accounting standards on determining an entity's functional currency using the Accounting Standards Codification. Garry has asked you, as an accountant in the controller's department, to research the functional currency issue. Write a memo to him, reporting the results of your research. Support your recommendations with citations and quotations from the authoritative financial reporting standards.

LO 12-5

C12-11 Accounting for the Translation Adjustment

Research

Sonoma Company has owned 100 percent of the outstanding common stock of Valencia Corporation, a Spanish subsidiary, for the past 15 years. The Spanish company's functional currency is the euro, and its financial statements are translated into U.S. dollars prior to consolidation.

In the current year, Sonoma sold 30 percent of Valencia's voting common stock to a nonaffiliated company. Sonoma's controller, Renee Voll, calculated a gain on the sale of this portion of its investment in Valencia. The consolidated balance sheet at the end of last year contained a debit balance cumulative translation adjustment related to the Spanish subsidiary. Voll believes that the decrease in Sonoma's share of Valencia's translation adjustment will be automatically included in other comprehensive income as the year-end translation adjustment is calculated and that Sonoma's share is included in the consolidated financial statements. However, she has asked you, as an accountant in her department, to research the accounting for the translation adjustment as a result of the sale of a part of the investment in the Spanish subsidiary.

Required

Research the most current standards on accounting for the translation adjustment resulting from translating the trial balance of a foreign affiliate using the Accounting Standards Codification. Write a memo to Renee reporting the results of your research. Support your recommendations with citations and quotations from the authoritative financial reporting standards.

Exercises

LO 12-4, 12-6

E12-1 Multiple-Choice Questions on Translation and Remeasurement [AICPA Adapted]

For each of the following seven cases, work the case twice and select the best answer. First assume that the foreign currency is the functional currency; then assume that the U.S. dollar is the functional currency.

1. Certain balance sheet accounts in a foreign subsidiary of Shaw Company on December 31, 20X1, have been restated in U.S. dollars as follows:

	Restated at	
	Current Rates	**Historical Rates**
Accounts Receivable, Current	$100,000	$110,000
Accounts Receivable, Long-Term	50,000	55,000
Prepaid Insurance	25,000	30,000
Patents	40,000	45,000
Total	$215,000	$240,000

What total should be included in Shaw's balance sheet for December 31, 20X1, for these items?

a. $215,000.
b. $225,000.
c. $230,000.
d. $240,000.

2. A wholly owned foreign subsidiary of Nick Inc. has certain expense accounts for the year ended December 31, 20X4, stated in local currency units (LCU) as follows:

	LCU
Depreciation of Equipment (related assets were purchased January 1, 20X2)	120,000
Provision for Uncollectible Accounts	80,000
Rent	200,000

The exchange rates at various dates were as follows:

	Dollar Equivalent of 1 LCU
January 1, 20X2	0.50
December 31, 20X4	0.40
Average, 20X4	0.44

What total dollar amount should be included in Nick's income statement to reflect the preceding expenses for the year ended December 31, 20X4?

a. $160,000.
b. $168,000.
c. $176,000.
d. $183,200.

3. Linser Corporation owns a foreign subsidiary with 2,600,000 local currency units (LCU) of property, plant, and equipment before accumulated depreciation on December 31, 20X4. Of this amount, 1,700,000 LCU were acquired in 20X2 when the rate of exchange was 1.5 LCU = $1, and 900,000 LCU were acquired in 20X3 when the rate of exchange was 1.6 LCU = $1. The rate of exchange in effect on December 31, 20X4, was 1.9 LCU = $1. The weighted average of exchange rates that were in effect during 20X4 was 1.8 LCU = $1. Assuming that the property, plant, and equipment are depreciated using the straight-line method over a 10-year period with no salvage value, how much depreciation expense relating to the foreign subsidiary's property, plant, and equipment should be charged in Linser's income statement for 20X4?

a. $144,444.
b. $162,000.
c. $169,583.
d. $173,333.

4. On January 1, 20X1, Pat Company formed a foreign subsidiary. On February 15, 20X1, Pat's subsidiary purchased 100,000 local currency units (LCU) of inventory. Of the original inventory purchased on February 15, 20X1, 25,000 LCU made up the entire inventory on December 31, 20X1. The exchange rates were 2.2 LCU = $1 from January 1, 20X1, to June 30, 20X1, and 2 LCU = $1 from July 1, 20X1, to December 31, 20X1. The December 31, 20X1, inventory balance for Pat's foreign subsidiary should be restated in U.S. dollars in the amount of

a. $10,500.
b. $11,364.
c. $11,905.
d. $12,500.

5. At what rates should the following balance sheet accounts in the foreign currency financial statements be restated into U.S. dollars?

	Equipment	Accumulated Depreciation of Equipment
a.	Current	Current
b.	Current	Average for year
c.	Historical	Current
d.	Historical	Historical

6. A credit-balancing item resulting from the process of restating a foreign entity's financial statement from the local currency unit to U.S. dollars should be included as a(an)
   a. Separate component of stockholders' equity.
   b. Deferred credit.
   c. Component of income from continuing operations.
   d. Extraordinary item.

7. A foreign subsidiary of the Bart Corporation has certain balance sheet accounts on December 31, 20X2. Information relating to these accounts in U.S. dollars is as follows:

	Restated at	
	Current Rates	Historical Rates
Marketable (AFS and Trading) securities	$ 75,000	$ 85,000
Inventories, carried at average cost	600,000	700,000
Refundable deposits	25,000	30,000
Goodwill	55,000	70,000
	$755,000	$885,000

What total should be included in Bart's balance sheet on December 31, 20X2, as a result of the preceding information?
   a. $755,000.
   b. $780,000.
   c. $870,000.
   d. $880,000.

LO 12-4, 12-5

E12-2 Multiple-Choice Questions on Translation and Foreign Currency Transactions [AICPA Adapted]

The following information should be used for questions 1, 2, and 3.

Select the best answers under each of two alternative assumptions: (*a*) the LCU is the functional currency and the translation method is appropriate or (*b*) the U.S. dollar is the functional currency and the remeasurement method is appropriate.

1. Refer to the preceding requirements. Gate Inc. had a $30,000 credit adjustment for the year ended December 31, 20X2, from restating its foreign subsidiary's accounts from their local currency units into U.S. dollars. Additionally, Gate had a receivable from a foreign customer payable in the customer's local currency. On December 31, 20X1, this receivable for 200,000 local currency units (LCU) was correctly included in Gate's balance sheet at $110,000. When the receivable was collected on February 15, 20X2, the U.S. dollar equivalent was $120,000. In Gate's 20X2 consolidated income statement, how much should be reported as foreign exchange gain in computing net income?
   a. $0.
   b. $10,000.
   c. $30,000.
   d. $40,000.

2. Refer to the preceding requirements. Bar Corporation had a realized foreign exchange loss of $13,000 for the year ended December 31, 20X2, and must also determine whether the following items will require year-end adjustment:

   (1) Bar had a $7,000 credit resulting from the restatement in dollars of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 20X2.

   (2) Bar had an account payable to an unrelated foreign supplier to be paid in the supplier's local currency. The U.S. dollar equivalent of the payable was $60,000 on the October 31, 20X2, invoice date and $64,000 on December 31, 20X2. The invoice is payable on January 30, 20X3.

   What amount of the net foreign exchange loss in computing net income should be reported in Bar's 20X2 consolidated income statement?

   a. $6,000.
   b. $10,000.
   c. $13,000.
   d. $17,000.

3. Refer to the preceding requirements. The balance in Simpson Corp.'s foreign exchange loss account was $15,000 on December 31, 20X2, before any necessary year-end adjustment relating to the following:

   (1) Simpson had a $20,000 debit resulting from the restatement in dollars of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 20X2.

   (2) Simpson had an account payable to an unrelated foreign supplier, payable in the supplier's local currency on January 27, 20X3. The U.S. dollar equivalent of the payable was $100,000 on the November 28, 20X2, invoice date, and $106,000 on December 31, 20X2.

   In Simpson's 20X2 consolidated income statement, what amount should be included as foreign exchange loss in computing net income?

   a. $41,000.
   b. $35,000.
   c. $21,000.
   d. $15,000.

4. When remeasuring foreign currency financial statements into the functional currency, which of the following items would be remeasured using a historical exchange rate?

   a. Inventories carried at cost.
   b. Trading securities carried at market values.
   c. Bonds payable.
   d. Accrued liabilities.

5. A foreign subsidiary's functional currency is its local currency, which has not experienced significant inflation. The weighted-average exchange rate for the current year would be the appropriate exchange rate for translating

	Sales to Customers	Wages Expense
a.	No	No
b.	Yes	Yes
c.	No	Yes
d.	Yes	No

6. The functional currency of Dahl Inc.'s subsidiary is the European euro. Dahl borrowed euros as a partial hedge of its investment in the subsidiary. In preparing consolidated financial statements, Dahl's debit balance of its translation adjustment exceeded its exchange gain on the borrowing. How should the translation adjustment and the exchange gain be reported in Dahl's consolidated financial statements?

a. The translation adjustment should be netted against the exchange gain, and the excess translation adjustment should be reported in the stockholders' equity section of the balance sheet.

b. The translation adjustment should be netted against the exchange gain, and the excess translation adjustment should be reported in the income statement in computing net income.

c. The translation adjustment is reported as a component of other comprehensive income and then accumulated in the stockholders' equity section of the balance sheet, and the exchange gain should be reported in the income statement in computing net income.

d. The translation adjustment should be reported in the income statement, and the exchange gain should be reported separately in the stockholders' equity section of the balance sheet.

LO 12-1–12-8

E12-3 Matching Terms

Match the descriptions on the left with the terms on the right. Terms may be used once, more than once, or not at all.

Descriptions of Terms	Terms
1. The group that has attempted to harmonize the world's many different accounting methods.	A. Financial Accounting Standards Board
2. The currency of the primary economic environment in which the entity operates.	B. Remeasurement gain or loss
3. The functional currency for a U.S. subsidiary located in a country with > 100 percent inflation over the last three years.	C. Translation adjustment
4. Translation of all assets and liabilities of a foreign subsidiary using the foreign exchange rate at the balance sheet date.	D. Current rate method
5. Restatement of the fixed assets and inventories of a foreign subsidiary into U.S. dollars using historical exchange rates.	E. Remeasurement method
6. Inclusion of this gain or loss on the U.S. company's income statement as part of net income.	F. U.S. dollar
7. The item that balances the debits and credits of the foreign subsidiary's adjusted trial balance in U.S. dollars, assuming the functional currency is the currency of the foreign subsidiary's country.	G. Functional currency
8. The item that balances the debits and credits of the foreign subsidiary's adjusted trial balance in U.S. dollars, assuming the functional currency is the U.S. dollar.	H. International Accounting Standards Board
9. Translation of the income statement accounts of a foreign subsidiary using the average exchange rate for the year.	I. International Managerial Accounting Society
10. Restatement of depreciation expense and cost of goods sold of a foreign subsidiary using historical exchange rates.	J. Functional currency indicators
11. An analysis of a foreign subsidiary's cash flows, sales prices, sales markets, expenses, and financing.	K. Historical rate method
12. The periodic change in this item reported as a component of other comprehensive income.	L. Cumulative transaction gain or loss

LO 12-4, 12-5

E12-4 Multiple-Choice Questions on Translation and Remeasurement

Use the following information for questions 1, 2, and 3.

Bartell Inc., a U.S. company, acquired 90 percent of the common stock of a Malaysian company on January 1, 20X5, for $160,000. The net assets of the Malaysian subsidiary amounted to 680,000 ringitts (RM) on the date of acquisition. On January 1, 20X5, the book values of the Malaysian subsidiary's identifiable assets and liabilities approximated their fair values. Exchange rates at various dates during 20X5 follow:

	RM $
January 1	1 = 0.21
December 31	1 = 0.24
Average for 20X5	1 = 0.22

1. Refer to the preceding information. On January 1, 20X5, how much goodwill was acquired by Bartell?

   a. $17,200.
   b. $31,480.
   c. $11,400.
   d. $25,360.

2. Refer to the preceding exchange rate information. Assume that Bartell acquired $10,500 of goodwill on January 1, 20X5, and the goodwill suffered a 10 percent impairment loss in 20X5. If the functional currency is the Malaysian ringgit, how much goodwill impairment loss should be reported on Bartell's consolidated income statement for 20X5?

   a. $1,050.
   b. $1,200.
   c. $1,100.
   d. $1,175.

3. Refer to the preceding information but now assume that the U.S. dollar is the functional currency. How much goodwill impairment loss should be reported on Bartell's consolidated income statement in this situation?

   a. $1,050.
   b. $1,200.
   c. $1,100.
   d. $1,175.

Use the following information for questions 4, 5, 6, and 7.

Mondell Inc., a U.S. company, acquired 100 percent of the common stock of a German company on January 1, 20X5, for $402,000. The German subsidiary's net assets amounted to €300,000 on the date of acquisition. On January 1, 20X5, the book values of its identifiable assets and liabilities approximated their fair values. As a result of an analysis of functional currency indicators, Mondell determined that the euro was the functional currency. On December 31, 20X5, the German subsidiary's adjusted trial balance, translated into U.S. dollars, contained $12,000 more debits than credits. The German subsidiary reported income of €25,000 for 20X5 and paid a cash dividend of €5,000 on November 30, 20X5. Included on the German subsidiary's income statement was depreciation expense of €2,500. Mondell uses the fully adjusted equity method of accounting for its investment in the German subsidiary and determined that goodwill in the first year had an impairment loss of 10 percent of its initial amount. Exchange rates at various dates during 20X5 follow:

	€ $
January 1	1 = 1.20
November 30	1 = 1.30
December 31	1 = 1.32
Average for 20X5	1 = 1.24

4. Refer to the preceding information. What amount should Mondell record as "income from subsidiary" based on the German subsidiary's reported net income?

   a. $31,000.
   b. $26,660.
   c. $33,000.
   d. $28,660.

5. Refer to the preceding information. The receipt of the dividend will result in

   a. A credit to the investment account for $6,200.
   b. A debit to the income from subsidiary account for $6,600.
   c. A credit to the investment account for $6,600.
   d. A credit to the investment account for $6,500.

6. Refer to the preceding information. On Mondell's consolidated balance sheet at December 31, 20X5, what amount should be reported for the goodwill acquired on January 1, 20X5?
   a. $37,660.
   b. $37,800.
   c. $41,580.
   d. $39,880.
7. Refer to the preceding information. In the stockholders' equity section of Mondell's consolidated balance sheet at December 31, 20X5, Mondell should report the translation adjustment as a component of other comprehensive income of
   a. $12,000.
   b. $15,920.
   c. $13,400.
   d. $8,080.

LO 12-4, 12-5

E12-5 Translation

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On January 1, 20X1, Popular Creek Corporation organized RoadTime Company as a subsidiary in Switzerland with an initial investment cost of Swiss francs (SFr) 60,000. RoadTime's December 31, 20X1, trial balance in SFr is as follows:

	Debit	Credit
Cash	SFr 7,000	
Accounts Receivable (net)	20,000	
Receivable from Popular Creek	5,000	
Inventory	25,000	
Plant & Equipment	100,000	
Accumulated Depreciation		SFr 10,000
Accounts Payable		12,000
Bonds Payable		50,000
Common Stock		60,000
Sales		150,000
Cost of Goods Sold	70,000	
Depreciation Expense	10,000	
Operating Expense	30,000	
Dividends Paid	15,000	
Total	SFr 282,000	SFr 282,000

Additional Information

1. The receivable from Popular Creek is denominated in Swiss francs. Popular Creek's books show a $4,000 payable to RoadTime.
2. Purchases of inventory goods are made evenly during the year. Items in the ending inventory were purchased November 1.
3. Equipment is depreciated by the straight-line method with a 10-year life and no residual value. A full year's depreciation is taken in the year of acquisition. The equipment was acquired on March 1.
4. The dividends were declared and paid on November 1.
5. Exchange rates were as follows:

	SFr $
January 1	1 = 0.73
March 1	1 = 0.74
November 1	1 = 0.77
December 31	1 = 0.80
20X1 average	1 = 0.75

6. The Swiss franc is the functional currency.

Required

Prepare a schedule translating the December 31, 20X1, trial balance from Swiss francs to dollars.

LO 12-4, 12-5 **E12-6 Proof of Translation Adjustment**

Refer to the data in Exercise E12-5.

Required

a. Prepare a proof of the translation adjustment computed in Exercise E12-5.

b. Where is the translation adjustment reported on Popular Creek's consolidated financial statements and its foreign subsidiary?

LO 12-6, 12-7 **E12-7 Remeasurement**

Refer to the data in Exercise E12-5, but assume that the dollar is the functional currency for the foreign subsidiary.

Required

Prepare a schedule remeasuring the December 31, 20X1, trial balance from Swiss francs to dollars.

LO 12-6, 12-7 **E12-8 Proof of Remeasurement Gain (Loss)**

Refer to the data in Exercises E12-5 and E12-7.

Required

a. Prepare a proof of the remeasurement gain or loss computed in Exercise E12-7.

b. How should this remeasurement gain or loss be reported on Popular Creek's consolidated financial statements and the financial statements of its foreign subsidiary?

LO 12-4, 12-5 **E12-9 Translation with Strengthening U.S. Dollar**

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Refer to the data in Exercise E12-5, but now assume that the exchange rates were as follows:

	SFr $
January 1	1 = 0.80
March 1	1 = 0.77
November 1	1 = 0.74
December 31	1 = 0.73
20X1 average	1 = 0.75

The receivable from Popular Creek Corporation is denominated in Swiss francs. Popular Creek's books show a $3,650 payable to RoadTime.

Assume the Swiss franc is the functional currency.

Required

a. Prepare a schedule translating the December 31, 20X1, trial balance from Swiss francs to dollars.

b. Compare the results of Exercise E12-5, in which the dollar is weakening against the Swiss franc during 20X1, with the results in this exercise (E12-9), in which the dollar is strengthening against the Swiss franc during 20X1.

LO 12-6, 12-7 **E12-10 Remeasurement with Strengthening U.S. Dollar**

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Refer to the data in Exercise E12-5, but now assume that the exchange rates were as follows:

	SFr $
January 1	1 = 0.80
March 1	1 = 0.77
November 1	1 = 0.74
December 31	1 = 0.73
20X1 average	1 = 0.75

The receivable from Popular Creek is denominated in Swiss francs. Its books show a $3,650 payable to RoadTime.

Assume that the U.S. dollar is the functional currency.

Required

a. Prepare a schedule remeasuring the December 31, 20X1, trial balance from Swiss francs to dollars.

b. Compare the results of Exercise E12-7, in which the dollar weakens against the Swiss franc during 20X1, with the results in this exercise (E12-10), in which the dollar strengthened against the Swiss franc during 20X1.

LO 12-5, 12-7 **E12-11 Remeasurement and Translation of Cost of Goods Sold**

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Duff Company is a subsidiary of Rand Corporation and is located in Madrid, Spain, where the currency is the euro (€). Data on Duff's inventory and purchases are as follows:

Inventory, January 1, 20X7	€220,000
Purchases during 20X7	846,000
Inventory, December 31, 20X7	180,000

The beginning inventory was acquired during the fourth quarter of 20X6, and the ending inventory was acquired during the fourth quarter of 20X7. Purchases were made evenly over the year. Exchange rates were as follows:

	€ $
Fourth quarter of 20X6	1 = 1.29015
January 1, 20X7	1 = 1.32030
Average during 20X7	1 = 1.39655
Fourth quarter of 20X7	1 = 1.45000
December 31, 20X7	1 = 1.47280

Required

a. Show the remeasurement of cost of goods sold for 20X7, assuming that the U.S. dollar is the functional currency.

b. Show the translation of cost of goods sold for 20X7, assuming that the euro is the functional currency.

LO 12-4 **E12-12 Equity-Method Entries for a Foreign Subsidiary**

Thames Company is located in London, England. The local currency is the British pound (£). On January 1, 20X8, Dek Company purchased an 80 percent interest in Thames for $400,000, which resulted in an excess of cost-over-book value of $48,000 due solely to a trademark having a remaining life of 10 years. Dek uses the equity method to account for its investment.

Thames' December 31, 20X8, trial balance has been translated into U.S. dollars, requiring a translation adjustment debit of $6,400. Thames's net income translated into U.S. dollars is $60,000. It declared and paid a £15,000 dividend on May 1, 20X8.

Relevant exchange rates are as follows:

	€ $
January 1, 20X8	1 = 1.60
May 1, 20X8	1 = 1.64
December 31, 20X8	1 = 1.65
Average for 20X8	1 = 1.63

Required

a. Record the dividend received by Dek from Thames.

b. Prepare the entries to record Dek's equity in the net income of Thames and the parent's share of the translation adjustment.

c. Show a calculation of the differential reported on the consolidated balance sheet of December 31, 20X8, and the translation adjustment from differential.

d. Record the amortization of the trademark on Dek's books.

e. Calculate the amount of the translation adjustment reported on the statement of comprehensive income as an element of other comprehensive income.

LO 12-5

E12-13 Effects of a Change in the Exchange Rate—Translation and Other Comprehensive Income

Bentley Company owns a subsidiary in India whose balance sheets in rupees (R) for the last two years follow:

	December 31, 20X6	December 31, 20X7
Assets:		
Cash	R 100,000	R 80,000
Receivables	450,000	550,000
Inventory	680,000	720,000
Fixed Assets, net	1,000,000	900,000
Total Assets	R2,230,000	R2,250,000
Equities:		
Current Payables	R 260,000	R 340,000
Long-Term Debt	1,250,000	1,100,000
Common Stock	500,000	500,000
Retained Earnings	220,000	310,000
Total Equities	R2,230,000	R2,250,000

Bentley formed the subsidiary on January 1, 20X6, when the exchange rate was 30 rupees for 1 U.S. dollar. The exchange rate for 1 U.S. dollar on December 31, 20X6, and December 31, 2007, had increased to 35 rupees and 40 rupees, respectively. Income is earned evenly over the year, and the subsidiary declared no dividends during its first two years of existence.

Required

a. Present both the direct and the indirect exchange rate for the rupees for the three dates of (1) January 1, 20X6, (2) December 31, 20X6, and (3) December 31, 20X7. Did the dollar strengthen or weaken in 20X6 and in 20X7?

b. Prepare the subsidiary's translated balance sheet as of December 31, 20X6, assuming the rupee is the subsidiary's functional currency.

c. Prepare the subsidiary's translated balance sheet as of December 31, 20X7, assuming the rupee is the subsidiary's functional currency.

d. Compute the amount that 20X7's other comprehensive income would include as a result of the translation.

LO 12-6

E12-14 Computation of Gain or Loss on Sale of Asset by Foreign Subsidiary

On December 31, 20X2, your company's Mexican subsidiary sold land at a selling price of 3,000,000 pesos. The land had been purchased for 2,000,000 pesos on January 1, 20X1, when the exchange rate was 10 pesos to 1 U.S. dollar. The exchange rate for 1 U.S. dollar was 11 pesos on December 31, 20X1, and 12 pesos on December 31, 20X2. Assume that the subsidiary had no other assets and no liabilities during the two years that it owned the land.

Required

a. Prepare all entries regarding the purchase and sale of the land that would be made on the books of the Mexican subsidiary whose recording currency is the Mexican peso.

b. Determine the amount of the gain or loss on the transaction that would be reported on the subsidiary's remeasured income statement in U.S. dollars, assuming the U.S. dollar is the functional currency. Determine the amount of the remeasurement gain or loss that would be reported on the remeasured income statement in U.S. dollars.

c. Determine the amount of the gain or loss on the transaction that would be reported on the subsidiary's translated income statement in U.S. dollars, assuming the Mexican peso is the functional currency. Determine the amount of the other comprehensive income that would be reported on the consolidated statement of other comprehensive income for 20X2.

LO 12-8

E12-15* Intercompany Transactions

Hawk Company sold inventory to United Ltd., an English subsidiary. The goods cost Hawk $8,000 and were sold to United for $12,000 on November 27, payable in British pounds. The goods are still on hand at the end of the year on December 31. The British pound (£) is the functional currency of the English subsidiary. The exchange rates follow:

	£	$
November 27	1	= 1.60
December 31	1	= 1.70

Required

a. At what dollar amount is the ending inventory shown in the trial balance of the consolidated worksheet?

b. What amount is eliminated for the unrealized intercompany gross profit, and at what amount is the inventory shown on the consolidated balance sheet?

Problems

LO 12-4

P12-16 Parent Company Journal Entries and Translation

On January 1, 20X1, Par Company purchased all the outstanding stock of North Bay Company, located in Canada, for $120,000. On January 1, 20X1, the direct exchange rate for the Canadian dollar (C$) was C$1 = $0.80. North Bay's book value on January 1, 20X1, was C$90,000. The fair value of North Bay's plant and equipment was C$10,000 more than book value, and the plant and equipment are being depreciated over 10 years with no salvage value. The remainder of the differential is attributable to a trademark, which will be amortized over 10 years.

During 20X1, North Bay earned C$20,000 in income and declared and paid C$8,000 in dividends. The dividends were declared and paid in Canadian dollars when the exchange rate was C$1 = $0.75. On December 31, 20X1, Par continues to hold the Canadian currency received from the dividend. On December 31, 20X1, the direct exchange rate is C$1 = $0.70. The average exchange rate during 20X1 was C$1 = $0.75. Management has determined that the Canadian dollar is North Bay's appropriate functional currency.

Required

a. Prepare a schedule showing the differential allocation and amortization for 20X1. The schedule should present both Canadian dollars and U.S. dollars.

b. Par uses the fully adjusted equity method to account for its investment. Provide the entries that it would record in 20X1 for its investment in North Bay for the following items:

(1) Purchase of investment in North Bay.

(2) Equity accrual for Par's share of North Bay's income.

(3) Recognition of dividend declared and paid by North Bay.

(4) Amortization of differential.

(5) Recognition of translation adjustment on differential.

c. Prepare a schedule showing the proof of the translation adjustment for North Bay as a result of the translation of the subsidiary's accounts from Canadian dollars to U.S. dollars. Then provide the entry that Par would record for its share of the translation adjustment resulting from the translation of the subsidiary's accounts.

d. Provide the entry required by Par to restate the C$8,000 in the Foreign Currency Units account into its year-end U.S. dollar–equivalent value.

LO 12-4, 12-5

P12-17 Translation, Journal Entries, Consolidated Comprehensive Income, and Stockholders' Equity

On January 1, 20X5, Taft Company acquired all of the outstanding stock of Vikix, Inc., a Norwegian company, at a cost of $151,200. Vikix's net assets on the date of acquisition were 700,000 kroner (NKr). On January 1, 20X5, the book and fair values of the Norwegian subsidiary's identifiable

*Indicates that the item relates to "Additional Considerations."

assets and liabilities approximated their fair values except for property, plant, and equipment and patents acquired. The fair value of Vikix's property, plant, and equipment exceeded its book value by $18,000. The remaining useful life of Vikix's equipment at January 1, 20X5, was 10 years. The remainder of the differential was attributable to a patent having an estimated useful life of 5 years. Vikix's trial balance on December 31, 20X5, in kroner, follows:

	Debits	Credits
Cash	NKr 150,000	
Accounts Receivable (net)	200,000	
Inventory	270,000	
Property, Plant, & Equipment	600,000	
Accumulated Depreciation		NKr 150,000
Accounts Payable		90,000
Notes Payable		190,000
Common Stock		450,000
Retained Earnings		250,000
Sales		690,000
Cost of Goods Sold	410,000	
Operating Expenses	100,000	
Depreciation Expense	50,000	
Dividends Paid	40,000	
Total	NKr1,820,000	NKr1,820,000

Additional Information

1. Vikix uses the FIFO method for its inventory. The beginning inventory was acquired on December 31, 20X4, and ending inventory was acquired on December 15, 20X5. Purchases of NKr420,000 were made evenly throughout 20X5.
2. Vikix acquired all of its property, plant, and equipment on July 1, 20X3, and uses straight-line depreciation.
3. Vikix's sales were made evenly throughout 20X5, and its operating expenses were incurred evenly throughout 20X5.
4. The dividends were declared and paid on July 1, 20X5.
5. Taft's income from its own operations was $275,000 for 20X5, and its total stockholders' equity on January 1, 20X5, was $3,500,000. Taft declared $100,000 of dividends during 20X5.
6. Exchange rates were as follows:

	NKr $
July 1, 20X3	1 = 0.15
December 30, 20X4	1 = 0.18
January 1, 20X5	1 = 0.18
July 1, 20X5	1 = 0.19
December 15, 20X5	1 = 0.205
December 31, 20X5	1 = 0.21
Average for 20X5	1 = 0.20

Required

a. Prepare a schedule translating the trial balance from Norwegian kroner into U.S. dollars. Assume the krone is the functional currency.

b. Assume that Taft uses the fully adjusted equity method. Record all journal entries that relate to its investment in the Norwegian subsidiary during 20X5. Provide the necessary documentation and support for the amounts in the journal entries, including a schedule of the translation adjustment related to the differential.

c. Prepare a schedule that determines Taft's consolidated comprehensive income for 20X5.

d. Compute Taft's total consolidated stockholders' equity at December 31, 20X5.

LO 12-6, 12-7 **P12-18 Remeasurement, Journal Entries, Consolidated Net Income, and Stockholders' Equity**

Refer to the information in Problem P12-17. Assume the U.S. dollar is the functional currency, not the krone.

Required

a. Prepare a schedule remeasuring the trial balance from Norwegian kroner into U.S. dollars.

b. Assume that Taft uses the fully adjusted equity method. Record all journal entries that relate to its investment in the Norwegian subsidiary during 20X5. Provide the necessary documentation and support for the amounts in the journal entries.

c. Prepare a schedule that determines Taft's consolidated net income for 20X5.

d. Compute Taft's total consolidated stockholders' equity at December 31, 20X5.

LO 12-7 **P12-19 Proof of Translation Adjustment**

Refer to the information presented in Problem P12-17 and your answer to part *a* of Problem P12-17.

Required

Prepare a schedule providing a proof of the translation adjustment.

LO 12-8 **P12-20 Remeasurement Gain or Loss**

Refer to the information given in Problem P12-17 and your answer to part *a* of Problem P12-18.

Required

Prepare a schedule providing a proof of the remeasurement gain or loss. For this part of the problem, assume that the Norwegian subsidiary had the following monetary assets and liabilities at January 1, 20X5:

Monetary Assets	
Cash	NKr 10,000
Accounts Receivable (net)	140,000
Monetary Liabilities	
Accounts Payable	NKr 70,000
Notes Payable	140,000

On January 1, 20X5, the Norwegian subsidiary has a net monetary liability position of NKr60,000.

LO 12-4, 12-5 **P12-21 Translation and Calculation of Translation Adjustment**

On January 1, 20X4, Alum Corporation acquired DaSilva Company, a Brazilian subsidiary, by purchasing all its common stock at book value. DaSilva's trial balances on January 1, 20X4, and December 31, 20X4, expressed in Brazilian reals (BRL), follow:

	January 1, 20X4		December 31, 20X4	
	Debit	**Credit**	**Debit**	**Credit**
Cash	BRL 62,000		BRL 57,700	
Accounts Receivable (net)	83,900		82,000	
Inventories	95,000		95,000	
Prepaid Insurance	5,600		2,400	
Plant & Equipment	250,000		350,000	
Accumulated Depreciation		BRL 67,500		BRL 100,000
Intangible Assets	42,000		30,000	
Accounts Payable		20,000		24,000
Income Taxes Payable		30,000		27,000
Interest Payable		1,000		1,100
Notes Payable		20,000		20,000

(*continued*)

	January 1, 20X4		December 31, 20X4	
	Debit	**Credit**	**Debit**	**Credit**
Bonds Payable		120,000		120,000
Common Stock		80,000		80,000
Additional Paid-In Capital		150,000		150,000
Retained Earnings		50,000		50,000
Sales				500,000
Cost of Goods Sold			230,000	
Insurance Expense			3,200	
Depreciation Expense			32,500	
Amortization Expense			12,000	
Operating Expense			152,300	
Dividends Paid			25,000	
Total	BRL538,500	BRL538,500	BRL1,072,100	BRL1,072,100

Additional Information

1. DaSilva uses FIFO inventory valuation. Purchases were made uniformly during 20X4. Ending inventory for 20X4 is composed of units purchased when the exchange rate was $0.25.
2. The insurance premium for a two-year policy was paid on October 1, 20X3.
3. Plant and equipment were acquired as follows:

Date	Cost
January 1, 20X1	BRL200,000
July 10, 20X2	50,000
April 7, 20X4	100,000

4. Plant and equipment are depreciated using the straight-line method and a 10-year life, with no residual value. A full month's depreciation is taken in the month of acquisition.
5. The intangible assets are patents acquired on July 10, 20X2, at a cost of BRL60,000. The estimated life is five years.
6. The common stock was issued on January 1, 20X1.
7. Dividends of BRL10,000 were declared and paid on April 7. On October 9, BRL15,000 of dividends were declared and paid.
8. Exchange rates were as follows:

	BRL $
January 1, 20X1	1 = 0.45
July 10, 20X2	1 = 0.40
October 1, 20X3	1 = 0.34
January 1, 20X4	1 = 0.30
April 7, 20X4	1 = 0.28
October 9, 20X4	1 = 0.23
December 31, 20X4	1 = 0.20
20X4 average	1 = 0.25

Required

a. Prepare a schedule translating the December 31, 20X4, trial balance of DaSilva from reals to dollars assuming the real is the functional currency.

b. Prepare a schedule calculating the translation adjustment as of the end of 20X4. The net assets on January 1, 20X4, were BRL280,000.

LO 12-8

P12-22 Remeasurement and Proof of Remeasurement Gain or Loss

Refer to the information in Problem P12-21. Assume that the dollar is the functional currency.

Required

a. Prepare a schedule remeasuring DaSilva Company's December 31, 20X4, trial balance from reals to dollars.

b. Prepare a schedule providing a proof of the remeasurement gain or loss.

LO 12-4, 12-5 **P12-23 Translation**

Alamo Inc. purchased 80 percent of the outstanding stock of Western Ranching Company, located in Australia, on January 1, 20X3. The purchase price in Australian dollars (A$) was A$200,000, and A$40,000 of the differential was allocated to plant and equipment, which is amortized over a 10-year period. The remainder of the differential was attributable to a patent. Alamo Inc. amortizes the patent over 10 years. Western Ranching's trial balance on December 31, 20X3, in Australian dollars is as follows:

	Debits	Credits
Cash	A$ 44,100	
Accounts Receivable (net)	72,000	
Inventory	86,000	
Plant & Equipment	240,000	
Accumulated Depreciation		A$ 60,000
Accounts Payable		53,800
Payable to Alamo Inc.		10,800
Interest Payable		3,000
12% Bonds Payable		100,000
Premium on Bonds		5,700
Common Stock		90,000
Retained Earnings		40,000
Sales		579,000
Cost of Goods Sold	330,000	
Depreciation Expense	24,000	
Operating Expenses	131,500	
Interest Expense	5,700	
Dividends Paid	9,000	
Total	A$942,300	A$942,300

Additional Information

1. Western Ranching uses average cost for cost of goods sold. Inventory increased by A$20,000 during the year. Purchases were made uniformly during 20X3. The ending inventory was acquired at the average exchange rate for the year.
2. Plant and equipment were acquired as follows:

Date	Cost
January 20X1	A$180,000
January 1, 20X3	60,000

3. Plant and equipment are depreciated using the straight-line method and a 10-year life with no residual value.
4. The payable to Alamo is in Australian dollars. Alamo's books show a receivable from Western Ranching of $6,480.
5. The 10-year bonds were issued on July 1, 20X3, for A$106,000. The premium is amortized on a straight-line basis. The interest is paid on April 1 and October 1.
6. The dividends were declared and paid on April 1.

7. Exchange rates were as follows:

	A$ $
January 20X1	1 = 0.93
August 20X1	1 = 0.88
January 1, 20X3	1 = 0.70
April 1, 20X3	1 = 0.67
July 1, 20X3	1 = 0.64
December 31, 20X3	1 = 0.60
20X3 average	1 = 0.65

Required

a. Prepare a schedule translating the December 31, 20X3, trial balance of Western Ranching from Australian dollars to U.S. dollars.

b. Prepare a schedule providing a proof of the translation adjustment.

LO 12-4

P12-24 Parent Company Journal Entries and Translation

Refer to the information given in Problem P12-23 for Alamo and its subsidiary, Western Ranching. Assume that the Australian dollar (A$) is the functional currency and that Alamo uses the fully adjusted equity method for accounting for its investment in Western Ranching.

Required

a. Prepare the entries that Alamo would record in 20X3 for its investment in Western Ranching. Your entries should include the following:

(1) Record the initial investment on January 1, 20X3.

(2) Record the dividend received by the parent company.

(3) Recognize the parent company's share of the equity income of the subsidiary.

(4) Record the amortizations of the differential.

(5) Recognize the translation adjustment required by the parent from the adjustment of the differential.

(6) Recognize the parent company's share of the translation adjustment resulting from the translation of the subsidiary's accounts.

b. Provide the necessary documentation and support for the amounts recorded in the journal entries, including a schedule of the translation adjustment related to the differential.

LO 12-5

P12-25 Consolidation Worksheet after Translation

Refer to the information given in Problems P12-23 and P12-24 for Alamo and its subsidiary, Western Ranching. Assume that the Australian dollar (A$) is the functional currency and that Alamo uses the fully adjusted equity method for accounting for its investment in Western Ranching. A December 31, 20X3, trial balance for Alamo Inc. follows. Use this translated trial balance for completing this problem.

Item	Debit	Credit
Cash	$ 38,000	
Accounts Receivable (net)	140,000	
Receivable from Western Ranching	6,480	
Inventory	128,000	
Plant & Equipment	500,000	
Investment in Western Ranching	152,064	
Cost of Goods Sold	600,000	
Depreciation Expense	28,000	
Operating Expenses	204,000	
Interest Expense	2,000	
Dividends Declared	50,000	
Translation Adjustment	22,528	

(*continued*)

Accumulated Depreciation		$ 90,000
Accounts Payable		60,000
Interest Payable		2,000
Common Stock		500,000
Retained Earnings, January 1, 20X3		179,656
Sales		1,000,000
Income from Subsidiary		39,416
Total	$1,871,072	$1,871,072

Required

a. Prepare a set of elimination entries, in general journal form, for the entries required to prepare a comprehensive consolidation worksheet (including other comprehensive income) as of December 31, 20X3.

b. Prepare a comprehensive consolidation worksheet as of December 31, 20X3.

LO 12-7

P12-26 Remeasurement

Refer to the information in Problem P12-23. Assume the U.S. dollar is the functional currency.

Required

a. Prepare a schedule remeasuring the December 31, 20X3, trial balance of Western Ranching from Australian dollars to U.S. dollars.

b. Prepare a schedule providing a proof of the remeasurement gain or loss. The subsidiary's net monetary liability position on January 1, 20X3, was A$80,000.

LO 12-6

P12-27 Parent Company Journal Entries and Remeasurement

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Refer to the information given in Problems P12-23 and P12-26 for Alamo and its subsidiary, Western Ranching. Assume that the U.S. dollar is the functional currency and that Alamo uses the fully adjusted equity method for accounting for its investment in Western Ranching.

Required

a. Prepare the entries that Alamo would record in 20X3 for its investment in Western Ranching. Your entries should do the following:

(1) Record the initial investment on January 1, 20X3.
(2) Record the dividend the parent company received.
(3) Recognize the parent company's share of the equity income from the subsidiary.
(4) Record the amortizations of the differential.

b. Provide the necessary documentation and support for the amounts recorded in the journal entries.

LO 12-7

P12-28 Consolidation Worksheet after Remeasurement

Refer to the information given in Problems P12-23 and P12-27 for Alamo and its subsidiary, Western Ranching. Assume that the U.S. dollar is the functional currency and that Alamo uses the fully adjusted equity method for accounting for its investment in Western Ranching. A December 31, 20X3, trial balance for Alamo follows. Use this remeasured trial balance for completing this problem.

Item	Debit	Credit
Cash	$ 38,000	
Accounts Receivable (net)	140,000	
Receivable from Western Ranching	6,480	
Inventory	128,000	
Plant & Equipment	500,000	
Investment in Western Ranching	178,544	
Cost of Goods Sold	600,000	
Depreciation Expense	28,000	
Operating Expenses	204,000	
Interest Expense	2,000	
Dividends Declared	50,000	

(*continued*)

Item	Debit	Credit
Accumulated Depreciation		$ 90,000
Accounts Payable		60,000
Interest Payable		2,000
Common Stock		500,000
Retained Earnings, January 1, 20X3		179,656
Sales		1,000,000
Income from Subsidiary		43,368
Total	$1,875,024	$1,875,024

Required

a. Prepare a set of elimination entries, in general journal form, for the entries required to prepare a three-part consolidation worksheet as of December 31, 20X3.

b. Prepare a three-part consolidation worksheet as of December 31, 20X3.

LO 12-6, 12-7 **P12-29 Foreign Currency Remeasurement [AICPA Adapted]**

On January 1, 20X1, Kiner Company formed a foreign subsidiary that issued all of its currently outstanding common stock on that date. Selected accounts from the balance sheets, all of which are shown in local currency units, are as follows:

	December 31	
	20X2	20X1
Accounts Receivable (net of allowance for uncollectible accounts of 2,200 LCU on December 31, 20X2, and 2,000 LCU on December 31, 20X1)	LCU 40,000	LCU 35,000
Inventories, at cost	80,000	75,000
Property, Plant, & Equipment (net of allowance for accumulated depreciation of 31,000 LCU on December 31, 20X2, and 14,000 LCU on December 31, 20X1)	163,000	150,000
Long-Term Debt	100,000	120,000
Common Stock, authorized 10,000 shares, par value 10 LCU per share; issued and outstanding, 5,000 shares on December 31, 20X2, and December 31, 20X1	50,000	50,000

Additional Information

1. Exchange rates are as follows:

	LCU $
January 1, 20X1–July 31, 20X1	2.0 = 1
August 1, 20X1–October 31, 20X1	1.8 = 1
November 1, 20X1–June 30, 20X2	1.7 = 1
July 1, 20X2–December 31, 20X2	1.5 = 1
Average monthly rate for 20X1	1.9 = 1
Average monthly rate for 20X2	1.6 = 1

2. An analysis of the accounts receivable balance is as follows:

	20X2	20X1
Accounts Receivable:		
Balance at beginning of year	LCU 37,000	
Sales (36,000 LCU per month in 20X2 and 31,000 LCU per month in 20X1)	432,000	LCU 372,000
Collections	(423,600)	(334,000)
Write-offs (May 20X2 and December 20X1)	(3,200)	(1,000)
Balance at end of year	LCU 42,200	LCU 37,000

	20X2	20X1
Allowance for Uncollectible Accounts:		
Balance at beginning of year	LCU 2,000	
Provision for uncollectible accounts	3,400	LCU 3,000
Write-offs (May 20X2 and December 20X1)	(3,200)	(1,000)
Balance at end of year	LCU 2,200	LCU 2,000

3. An analysis of inventories, for which the first-in, first-out inventory method is used, follows:

	20X2	20X1
Inventory at beginning of year	LCU 75,000	
Purchases (June 20X2 and June 20X1)	335,000	LCU375,000
Goods available for sale	LCU410,000	LCU375,000
Inventory at end of year	(80,000)	(75,000)
Cost of goods sold	LCU330,000	LCU300,000

4. On January 1, 20X1, Kiner's foreign subsidiary purchased land for 24,000 LCU and plant and equipment for 140,000 LCU. On July 4, 20X2, additional equipment was purchased for 30,000 LCU. Plant and equipment is being depreciated on a straight-line basis over a 10-year period with no residual value. A full year's depreciation is taken in the year of purchase.
5. On January 15, 20X1, 7 percent bonds with a face value of 120,000 LCU were issued. These bonds mature on January 15, 20X7, and the interest is paid semiannually on July 15 and January 15. The first interest payment was made on July 15, 20X1.

Required

Prepare a schedule remeasuring the selected accounts into U.S. dollars for December 31, 20X1, and December 31, 20X2, respectively, assuming the U.S. dollar is the functional currency for the foreign subsidiary. The schedule should be prepared using the following form:

Item	Balance in LCU	Appropriate Exchange Rate	Remeasured into U.S. Dollars
December 31, 20X1:			
Accounts Receivable (net)			
Inventories			
Property, Plant, & Equipment (net)			
Long-Term Debt			
Common Stock			
December 31, 20X2:			
Accounts Receivable (net)			
Inventories			
Property, Plant, & Equipment (net)			
Long-Term Debt			
Common Stock			

LO 12-4, 12-5 **P12-30 Foreign Currency Translation**

Refer to the information in Problem P12-29 for Kiner Company and its foreign subsidiary.

Required

Prepare a schedule translating the selected accounts into U.S. dollars as of December 31, 20X1, and December 31, 20X2, respectively, assuming that the local currency unit is the foreign subsidiary's functional currency.

LO12-1–12-8 **P12-31 Matching Terms**

Match the items in the left-hand column with the descriptions/explanations in the right-hand column.

Items	Descriptions/Explanations
1. Current exchange rate	A. Method used to restate a foreign entity's financial statement when the local currency unit is the functional currency.
2. Foreign entity goodwill under translation	B. Method used to restate a foreign entity's financial statements when the U.S. dollar is the functional currency.
3. Increase in the translation adjustment for the year	C. Currency of the environment in which an entity primarily generates and expends cash.
4. Other comprehensive income—translation adjustment	D. Always the local currency unit of the foreign entity.
5. Translation	E. Exchange rate at the end of the period.
6. Historical exchange rate	F. Exchange rate at the date of the asset acquisition or at the date of dividend declaration.
7. Foreign entity goodwill under remeasurement	G. Average exchange rate during the period.
8. Remeasurement	H. Periodic change in the cumulative translation adjustment.
9. A decrease in the translation adjustment for the year	I. Method under which goodwill must be adjusted to the current exchange rate at the balance sheet date.
10. Functional currency	J. Method under which goodwill is restated using the historical exchange rate.
	K. Increase of the exchange rate during the year.
	L. Decrease of the exchange rate during the year.

LO 12-4 **P12-32 Translation Choices**

The U.S. parent company is preparing its consolidated financial statements for December 31, 20X4. The foreign company's local currency (LCU) is the functional currency. Information is presented in Data Set A and Data Set B.

Data Set A:

	Exchange Rate	Date
1.	LCU 0.74	June 16, 20X1: date foreign company purchased
2.	0.80	January 1, 20X4: beginning of current year
3.	0.87	March 31, 20X4
4.	0.86	June 12, 20X4
5.	0.85	Average for year 20X4
6.	0.84	November 1, 20X4
7.	0.83	December 31, 20X4: end of current year
8.	No translation rate is applied	

Data Set B:

a. Accounts receivable outstanding from sales on March 31, 20X4.
b. Sales revenue earned during year.
c. Dividends declared on November 1, 20X4.
d. Ending inventory balance from acquisitions through the year.
e. Equipment purchased on March 31, 20X4.
f. Depreciation expense on equipment.
g. Common stock outstanding.
h. Dividends payable from dividends declared on June 12, 20X4.
i. Accumulated Other Comprehensive Income balance from prior fiscal year.
j. Bond payable issued January 1, 20X4.
k. Interest expense on the bond payable.

Required

a. Select the appropriate exchange rate from the amounts presented in Data Set A to prepare the translation worksheet for each of the accounts presented in Data Set B.

b. Determine the direct exchange rate for January 1, 20X4.

c. Determine whether the U.S. dollar strengthened or weakened against the LCU during 20X4.

LO 12-5

P12-33 Proof of Translation Adjustment

MaMi Co. Ltd. located in Mexico City is a wholly owned subsidiary of Special Foods, a U.S. company. At the beginning of the year, MaMi's condensed balance sheet was reported in Mexican pesos (MXP) as follows:

Assets	3,425,000	Liabilities	2,850,000
		Stockholders' Equity	575,000

During the year, the company earned income of MXP270,000 and on November 1 declared dividends of MXP150,000. The Mexican peso is the functional currency. Relevant exchange rates between the peso and the U.S. dollar follow:

January 1 (beginning of year)	$0.0870
Average for year	0.0900
November 1	0.0915
December 31 (end of year)	0.0930

Required

a. Prepare a proof of the translation adjustment, assuming that the beginning credit balance of the Accumulated Other Comprehensive Income—Translation Adjustment was $3,250.

b. Did the U.S. dollar strengthen or weaken against the Mexican peso during the year?

Kaplan CPA Review

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Situation

The Montana Corporation, based in Billings, transacts business in the United States and Mexico. Its wholly owned subsidiary (Cabo, Inc.) is located in Mexico. Both companies assume the United States dollar as their functional currency.

Consolidated financial statements are being prepared for Year One. Montana Corp. and Cabo, Inc., have a December 31 year-end. The currency exchange rates are as follows for the current year (Year One):

January 1, Year One:	1 peso equals $.088
Average for Year One:	1 peso equals $.090
November 1, Year One:	1 peso equals $.092
December 1, Year One:	1 peso equals $.094
December 31, Year One:	1 peso equals $.095
January 31, Year Two:	1 peso equals $.098

Topics covered in the simulation

a. Foreign currency translation.

b. Foreign currency remeasurement.