ISSUES INVOLVING FOREIGN CURRENCY

I. SFAS No. 52. "Foreign Currency Translation"

A. Background: In SFAS No. 8 "Foreign Currency Translation" the FASB stated that the objective of translation was

- to measure and express US dollars and in conformity with US GAAP the assets, liabilities, revenues and expenses that are measured or denominated in a foreign currency.

In order to achieve this, SFAS N0.8 required the use of the "*temporal method*".

- The **Temporal Method** translates receivables and payables at the exchange rate in effect at the statement date (the temporal date) while other assets and liabilities were translated at rates reflecting their valuation basis (e.g., assets carried at historical cost are translated at historical rates and those carried at current values such as MES are translated at the current rate. **This use of differing translation basis resulted in unrealized translation gains and losses that were reported on the income statement**.

The fact that SFAS No. 8 resulted in recognition of translation gains and losses on the income statement caused considerable controversy because reporting entities reported significant fluctuation in profits as a result of variations foreign currency exchange rates. Opponents of SFAS No. 8 pointed out that this increased volatility in reported income did not reflect the underlying economic substance of the transactions for two reasons:

a. No actual gain or loss on a transaction denominated in a foreign currency actually occurred as a result of exchange rate fluctuations until that foreign currency was converted back into US dollars and

b. No actual gain or loss on investment in the foreign subsidiary currency actually occurred as a result of exchange rate fluctuations because those foreign securities had to be liquidated back into the foreign currency. Therefore the actual gain or loss should not be recognized until the liquidated funds were converted into US dollars.

B. The Issue: The real issue was the volatility of reported earnings caused by temporal method translation. In SFAS No. 52 steps were taken to remove the effects of foreign currency translation adjustments off of the income statement and onto the balance sheet in order to eliminate the effects of currency fluctuations on reported income unless they actually had an income effect.

C. The Solution: SFAS No. 52 which supersedes Statements 8 and 20 and their related interpretations and had two principle objectives:

1. provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity and
2. reflect in the consolidated financial statements the financial results land relationships of the individual consolidated entities as measured in their functional currencies in conformity with US GAAP.

FASB-52 attempts to solve the volatility of reported income by removing those foreign currency fluctuation effects that have little relationship to reported income off of the income statement and on to the balance sheet. This is done by creating a "foreign functional currency" and requiring that only those adjustments that involve foreign currency transactions and/or adjustments between other foreign currencies and the "functional currency" will be reported on the income statement; all other foreign currency fluctuation effects will be reported on the balance sheet.

II. Removing Foreign Currency Translations from the Income Statement (NOTE: all translation effects go the balance sheet)

A. Functional currency:

1. The FASB's strategy to remove the effects of currency fluctuations from the income statement was based on a new concept called the Functional Currency. The FASB defined a company's Functional currency as

- "...the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash." Normally a company's functional currency is readily apparent. If in doubt, SFAS 52 provides a series of factors to be considered in determining the functional currency; there are essentially three possibilities:
    1. **The local currency is presumed to be the functional currency if:**
        a. the **sales price** of the foreign entity's products are determined by the local competition or local government regulations, rather than by short-run exchange rate changes or worldwide markets;
        b. **Expenses are incurred for local labor and material** and are paid for in the local currency;
        c. The **cost of financing is primarily denominated in the local currency** and funds generated by local operations are sufficient service existing and expected debt;
    2. **The parent's reporting currency (US dollar) is presumed to be the functional currency if:**
        a. a subsidiary is primarily as **sales subsidiary of a US Parent** and sales contracts are normally denominated in US dollars, the **US dollar is the functional currency;**

b. a **high volume of intercompany transactions** and other intercompany arrangements is denominated in US dollars

3. **The currency of a third county is presumed to be the functional currency if:**
   a. The subsidiary denominates the bulk of its transactions in this other currency and
   b. The subsidiary has a relatively insignificant amounts of transactions in the local currency

Summary of Functional Currency Selection Criteria

1. The functional currency of a foreign entity may be its local currency, the US dollar, or another foreign currency.

a. Functional Currency = Local Currency: operations are relatively self-contained (i.e. most activities are performed independently of the parent company) and integrated within one country. Translation will be required into US dollars as described in Section B below.

b. US dollar is functional currency: foreign operation is essentially an extension of the parent's US operation (e.g. a sales branch that purchases all its inventory from the US home office in US dollars).

1. If foreign subsidiaries books are kept in local currency, then remeasurement in to US dollars will be required as described in Section C below. A gain or loss from remeasurement will be included in the foreign entity's net income.

2. If foreign subsidiaries books are kept in US dollars, then its trial balance can be directly incorporated into the parent's financial statements. Transactions denominated in foreign currency will result in foreign currency gains and losses, accounted for as indicated in section III below. The net gain or loss will be a "remeasurement" (as opposed to a translation and the resulting gain or loss will be reflected on the income statement. In other words, if the US dollar is the functional currency but transactions are predominately made in the local foreign currency, then the aggregate net gain or loss from exchange fluctuations will be the same as they were under FASB-8, regardless of whether the foreign subsidiary keeps its books in the local currency or US dollars.

c. Other foreign currency is the functional currency: the foreign subsidiary may keep its books on the local (recording) currency but use the currency of yet another foreign country as its functional currency. In this case, remeasuring of the recording currency statements into functional currency will be required as described in section C below. Once the statements have been remeasured into the functional currency, and then translation into US dollars is required as described in section B below.

d. Highly inflationary economies: If a foreign country's cumulative inflation rate for the three years preceding the date of the financial statements is approximately 100% or more, the local currency is not considered stable enough to the functional currency. In this case the reporting currency (US dollars) will be the functional currency, and remeasurement will be required.

B. Translation of Foreign Currency Financial Statements (Sub books kept in foreign functional currency)

1. Prior to translation, the foreign currency statements must be conformed to US GAAP and be measured in the functional currency of the foreign entity (If Sub does not maintain its books in its functional currency, remeasurement is required as described in section C below).

2. Foreign currency financial statements should be translated using the following rates:

a. Assets and liabilities: exchange rate at balance sheet date
b. Revenues and expenses: Exchange rate when revenue or expense was realized or weighted average for the period
c. Intercompany profits: Same as other revenues and expenses
d. Contributed capital: Historical rate (rate in effect when acquired)
e. Retained earnings: Translated amount of BOY RE + or - net income or loss (at the weighted average rate) less dividends at rate when declared

Translation of foreign currency statements as described above will result in a translation adjustment. This translation adjustment is reported as a separate component of owners equity and is not included in the determination of net income.

Thumbnail Summary of SFAS-52

Any Foreign Currency — Functional Currency — U.S. Dollar
Subsidiary Books — Parent Books

Remeasurements Affect the Income Statement	Translation Adjustments Affect the Balance Sheet
Monetary Items: Remeasured at the current (BS) rate	Real Accounts: translated at current rate (BS date)
Non-monetary Items: Use historical or Wtd Avg rage	Nominal Accounts: Historical or Wtd Avg Rate
	PIC Accounts: Historical rate

All foreign currency transactions and forward contracts except as noted are remeasurements (affect the Income Statement)

Income Statement Adjustments:			Balance Sheet Adjustments:		
Loss:			Loss:		
Exchange loss..................	xxxx		Owners Equity--Translation Adjustments.......	xxxx	
Currency Value (asset).......		xxxx	Investment in Subsidiary.................		xxxx
Gain:			Gain:		
Currency Value (asset).............	xxxx		Investment in Sub (to historical cost only)..	xxxx	
Exchange gain...............		xxxx	Owners Equity--Translation Adjustments...		xxxx

Example 1: Translation Adjustments

San Diego, Inc. as U. S. corporation, owns 40% of the outstanding common stock of Franco Ltd, a French company. Franco's financial statements for the year ended 12/31/x1 are presented below:

Franco, Ltd.
Balance Sheet
Year Ended 12/31/x1

Assets	French Francs
Cash................................	262,500
Accounts Receivable.................	350,000
Inventory...........................	787,500
Property, Plant and Equipment.......	2,100,000
Total Assets......................	3,500,000
Liabilities and Equity	
Accounts payable....................	(175,000)
Notes payable.......................	(875,000)
Common Stock........................	(700,000)
Paid in capital in excess of par.....	(525,000)
Retained earnings (12/31/x1).........	(1,225,000)
Total liabilities and equity.......	(3,500,000)

Franco, Ltd.
Income Statement
For Period 1/1/x1-12/31/x1

	French Francs
Sales Revenues....................	(700,000)
Cost of Sales.....................	262,500
Gross margin on sales............	(437,500)
General and Administrative Exp....	175,000
Net Income.......................	(262,500)

Additional Information:
--Exchange rate information for 19x1:

1/1/x1..............................	1FF = $0.190
7/1/x1..............................	1FF = $0.180
12/31/x1............................	1FF = $0.175
Weighted Average for year.	1FF = $0.178

--Franco's translated 1/1/x1 retained earnings was $240,000
--The exchange rate in effect when Franco was acquired was 1FF = $0.200
--On 7/1/x1 Franco paid a 87,500 FF dividend

Required:

a. State whether Franco's financial statements should be translated or remeasured and explain the rationale for your response.

b. Present Franco's 12/31/x1 financial statements in U.S. $ providing schedules detailing the derivation of all computed numbers;

c. Assuming no intercompany transactions occurred during the year, present all necessary journal entries required to account for San Diego's investment in Franco for the year.

Solution: Example 1

Solution part a: The functional currency used by Franco is the French Franc (FF). Any and all adjustments between a foreign functional currency and the US $ are translation adjustments. Therefore the financial statements will be translated, not remeasured. This means that the affects of changing foreign currency exchange rates will be reflected on the balance sheet and not on the income statement.

Solution part b: Producing Translated Financial Statements

Franco, Ltd.
Balance Sheet
Year Ended 12/31/x1

Assets	French Francs	Exchange Rate	U.S. Dollars
Cash................................	262,500	.175	$ 45,937.50
Accounts Receivable.................	350,000	.175	61,250.00
Inventory...........................	787,500	.175	137,812.50
Property, Plant and Equipment........	2,100,000	.175	367,500.00
Total Assets......................	3,500,000		$ 612,500.00
Liabilities and Equity			
Accounts payable....................	(175,000)	.175	$ (30,625.00)
Notes payable.......................	(875,000)	.175	(153,125.00)
Common Stock........................	(700,000)	.200	(140,000.00)
Paid in capital in excess of par.....	(525,000)	.200	(105,000.00)
Retained earnings (12/31/x1).........	(1,225,000)	Schedule A	(270,975.00)
Translation Adjustment (Plug)........	---		87,225.00
Total liabilities and equity.......	(3,500,000)		$ (612,500.00)

Note: It must be understood that RE cannot be computed directly (like the other items are). RE is the confluence of BOY +NI-Div etc, each of which must be computed independently!

Franco, Ltd.
Income Statement
For Period 1/1/x1-12/31/x1

	French Francs	Exchange Rate	U.S. Dollars
Sales Revenues.....................	(700,000)	.178	$ (124,600.00)
Cost of Sales......................	262,500	.178	46,725.00
Gross margin on sales..............	(437,500)	.178	(77,875.00)
General and Administrative Exp......	175,000	.178	31,150.00
Net Income.........................	(262,500)		$ (46,725.00)

Schedule A:

Computation of 12/31/x1 Translated Retained Earnings

Retained Earnings 1/1/x1 (Translated)..................... $	(240,000)
Net Income (Translated)...................................	(46,725)
Less: Dividends [(87,500)(.18)]...........................	15,750
Retained Earnings 12/31/x2 (Translated)................ $	(270,975)

Solution part c: Consolidated Journal Entries (no intercompany transactions)

		Dr	Cr
7/1/x1	Cash (87,500)(.18)(.4)..................	6,300	
	Investment in Franco..................		6,300
	To record receipt of cash dividend from Franco (Equity Method: APB-18)		

		Dr	Cr
12/31/x1	Investment in Franco (46,727)(.4).........	18,690	
	Investment Revenue....................		18,690
	Record Investment Revenue (Equity Method: APB-18)		

		Dr	Cr
12/31/x1	Owners Equity--Translation Adjustments....	34,890	
	Investment in Franco (87,225)(.4).....		34,890
	Record pro rata share of translation adjustment		

Example 2: Translation Adjustments Applied to a Sale of an Ownership Interest

Using the same facts as Example 1, assume that San Diego had paid $200,000 for its 40% interest on 1/1/x1. If San Diego sells 25% of its ownership interest in Franco for $50,000 on 1/1/x2, provide the journal entry to record the sale.

Solution Part c: Sale of an ownership interest

		Dr	Cr
1/1/x2	Cash......................................	50,000	
	Loss on sale of 25% interest in Franco....	3,098	
	Owners Eq.--Trans Adj (.25)(34,890)..		8,723
	Investment in Franco (Schedule B)....		44,375

Schedule B: Book Value of Investment in Franco

Cost...........	$	200,000
Adjustments:		(6,300)
		18,690
		(34,890)
	$	177,500
Percentage sold		.25
BV of portion sold	$	44,375

C. Remeasurement Into Functional Currency

1. If a subsidiary does not maintain its books in its functional currency, remeasuring into the functional currency is required prior to translation into the reporting currency (i.e., the US dollar).

2. The remeasuring process should achieve the same result as if the books had been initially recorded in the functional currency; all adjustments required to achieve this end as part of the remeasurement process will result in "remeasurement gains and losses (exchange gains and losses)" that will be reported on the income statement.
   a. Non-monetary accounts: remeasured using the historical rate (This includes revenues and expenses related to non-monetary assets; examples include
      --cost of goods sold
      --depreciation
      --amortization of deferred charges or credits except deferred income
   b. Monetary assets are remeasured at the current rate

3. The remeasuring process will result in exchange gains and losses which will be recognized in the net income of the current period.

4. Note that this "remeasuring process" is essentially the same as the temporal method of SFAS 8 with the exception that deferred income taxes and policy acquisition costs of life insurance companies are remeasured under the current exchange rates under SFAS 52.

Example 3: Remeasurement of Income

Espanola S.A., a Spanish *sales subsidiary* was formed on 1/1/x1 and is considered a foreign extension of its U.S. Parents' operations. Espanola is 100% owned by Pancho, Inc, a U. S. Corporation.

Additional Information:

--Exchange rate information for 19x1:

1/1/x1..............................	1 peseta = $1.00
5/5/x1..............................	1 peseta = $ .98
7/1/x1..............................	1 peseta = $ .96
12/31/x1..........................	1 peseta = $ .90
Weighted Average for year..........	1 peseta = $ .95

--Espanola's inventories are carried at weighted average cost

--The building and property on which Espanola's offices are located was purchased on 5/5/x1 for 800,000 pesetas

--On 7/1/x1 Espanola paid a 50,000 peseta dividend

--Espanola's financial statements as of 12/31/x1 are presented below:

Espanola S.A.
Balance Sheet
Year Ended 12/31/x1

Assets	Pesetas
Cash................................	200,000
Inventory (weighted average cost)....	500,000
Property, Plant and Equipment (net).	800,000
Total Assets......................	1,500,000
Liabilities and Equity	
Accounts payable....................	(300,000)
Mortgage notes payable..............	(600,000)
Common Stock........................	(350,000)
Retained earnings (12/31/x1).........	(250,000)
Total liabilities and equity.......	(1,500,000)

Espanola S.A.
Income Statement
For period 1/1/x1 to 12/31/x1

	Pesetas
Sales Revenues.....................	(700,000)
Cost of Sales......................	350,000
Gross margin on sales..............	(350,000)
General and Administrative Exp.	100,000
Net Income.........................	(250,000)

REQUIRED:

a. State whether Espanola's financial statements will be translated or remeasured and provide the rationale for your response.
b. Present the translated or remeasured financial statements of Espanola and schedules for all computed numbers.
c. Present the necessary journal entries to record the remeasurement effects.

Solution part a:The functional currency of Espanola will be the US $ because Espanola is merely a foreign sales branch of the US parent. Therefore, Espanola's financial statements will be remeasured rather than translated. This is because all adjustments to the US $ will be between a foreign currency that is not the functional currency. Recall that only adjustments between the foreign functional currency and the US $ can be translations. All adjustments between any other foreign currency (that is not the functional currency) and the US $ must be remeasurements.

Solution Part b: Present the remeasured financial statements

Espanola S.A.
Balance Sheet
Year Ended 12/31/x1

Assets	Pesetas	Exchange Rate	U.S. Dollars
Cash................................	200,000	.9	$ 180,000
Inventory (weighted average cost)....	500,000	.95	475,000
Property, Plant and Equipment (net).	800,000	.98	784,000
Total Assets......................	1,500,000		$ 1,439,000
Liabilities and Equity			
Accounts payable....................	(300,000)	.9	$(270,000)
Mortgage notes payable..............	(600,000)	.9	(540,000)
Common Stock........................	(350,000)	1.0	(350,000)
Retained earnings (12/31/x1).........	(250,000)	Plug	(279,000)
Total liabilities and equity.......	(1,500,000)		$(1,439,000)

Espanola S. A.
Income Statement
For Period 1/1/x1-12/31/x1

	Pesetas	Exchange Rate	U.S. Dollars
Sales Revenues.....................	(700,000)	.95	$(665,000)
Cost of Sales......................	350,000	.95	332,500)
Gross margin on sales..............	(350,000)	.95	(332,500)
General and Administrative Exp......	100,000	.95	95,000
Exchange (gain) or loss............		Schedule A	(89,500)
Net Income.........................	(250,000)	Schedule B	$(327,000)

Schedule A:

Computation of 12/31/x1 Exchange (Gain) or Loss:

Retained Earnings 1/1/x1	$	(-0-)
Net Income (250,000)(.95)................................		(237,500)
Less: Dividends [(50,000)(.96)]...........................		48,000
Retained Earnings adjusted................................	$	(189,500)
Exchange (gain) or loss...................................		(89,500)
Retained Earnings 12/31/x2 (plug from balance sheet)..	$	(279,000)

Schedule B:

Computation of Remeasured Net Income:

Net income (250,000)(.95)..........	$	237,500
Add: Exchange gain (Schedule A).....		89,500
Remeasured Net income..............	$	327,000

Solution c: Record the journal entries to reflect the foreign currency effects:

12/31/x1	Investment in Espanola..........................	327,000	
	Equity in earnings of Subsidiary.............		327,000
	Record equity in earnings of Sub		

III. FOREIGN CURRENCY TRANSACTIONS

A. Overview

1. Foreign transactions are simply transactions between enterprises in different countries. Foreign currency transactions are foreign transactions denominated in a currency other than the entities functional currency. These transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid (monetary items). **Note that foreign transactions may or may not be foreign currency transactions.** For example, a sale by a US company to a foreign company is a foreign currency transaction (from the US perspective) only if the contract is denominated in the foreign currency. **This is an important distinction because the provisions of SFAS No. 52 apply only to foreign currency transactions and foreign currency financial statements.**

2. Changes in exchange rates between functional currency and recording currency result in increases or decreases in the amount of functional currency cash flows upon settlement of the transaction. That increase or decrease is a foreign currency transaction gain or loss that generally should be included in the determination of net income of the period in which the exchange rate changes.

B. The General Rule For Foreign Currency Transactions (Other than Forward Contracts): SFAS No. 52 requires a two step approach to foreign currency transactions:

1. transaction date: record each asset, liability, revenue, expense, gain or loss in the functional currency of the recording entity using the exchange rate in effect on that date.

2. balance sheet date: recorded balances that are denominated in a currency other that the functional currency of the recording entity should be adjusted to reflect the current exchange rate.

Example 4: Foreign Currency Transactions

On 11/1/x1, Americana, Inc. (a US corporation), purchased equipment from an unrelated French company for 10,000 French Francs, payable on 1/30/x2. The exchange rate information is as follows:

--Exchange rate information:

11/1/x1............................. 1 franc = $0.30 (Spot Rate)
12/31/x1............................ 1 franc = $0.32
1/30/x2............................. 1 franc = $0.33

REQUIRED:Present all necessary journal entries to account for this transaction on Americana's books

Solution Example 4: Foreign Currency Transactions

11/1/x1 (Date of the contract)

Equipment (10,000)(.3)....................	3,000	
Note payable..........................		3,000
To record the purchase at the cash equivalent price on the date of sale		

12/31/x1 (Balance Sheet Date)
Exchange loss (10,000)(.32-.30)............ 200
Note payable............................ 200
To record loss in purchasing power of the dollar due to putting off payment until 1/30/x2

1/31/x2 (Date of Payment)
Note payable (3,000 + 200).................. 3,200
Exchange loss (plug)........................ 100
Cash (cost of 10,000 FF @ current rate... 3,300

C. Forward Exchange Contracts (forward contracts): are agreements to exchange different currencies at a specified future date at a specified rate (the forward rate). **Currency swaps** and other agreements that are essentially the same as forward contracts are considered forward contracts for the purpose of applying the provisions of SFAS No. 52. **SFAS No. 52 recognizes four categories of forward exchange contracts:**

Category 1: Speculation in foreign currency exchange price movements:

Because foreign currencies are traded as commodities, companies may invest in these commodities for strictly speculative purposes. Forward contracts held for speculative purposes are valued at the forward rate at all times during the life of the contract. Gains and losses on speculative forward contracts result in changes between the current forward rate and previous forward rates and are recognized in the reported income of the period. **Note** that no recognition is given to premium or discounts on the forward contracts held for speculative purposes.

Example 5: Speculative Forward Contracts Illustrated:
On 11/1/x1 US Co. purchases a 90 day future contract for 100,000 Foreign Currency Units (FCU).
--Spot rate on 11/1/x1: $ .0103
--90 day Forward rate on 11/1/x1: $ .0105
--30 day Forward rate on 12/31/x1: $ .0106
--Spot rate on 2/1/x2: $ .0107

REQUIRED: Present the required journal entries to reflect this transaction IAW SFAS No. 52.

Solution Example 5: Speculative Forward Contracts:
Date Contract Signed (11/1/x1)
FCU due from broker (100,000)(.0105)........................ 1,050
Contract payable to broker.............................. 1,050
To record contract at the 90 day forward rate

Balance Sheet Date (12/31/x1)
FCU due from broker (100,000)(.0106 -.0105)...... . 10
Exchange gain... 10
To recognize due to change in the current forward rate

Date Contract is Due (2/1/x1)
Contract payable to broker (100,000)(.0105)k........ 1,050
Cash.. 1,050
To record payment to broker at contract price

Cash (cash value of FCU received at current spot rate)..... 1,070
FCU due from broker (1,050 + 10)....................... 1,060
Exchange gain (100,000)(.0107 - .0106)................ 10
To record receipt of cash value of 100,000 FCU at the current spot rate

Category 2: Hedges on exposed foreign currency net asset or net liability positions.

Exposed Net Asset Position: An excess of net assets denominated in FCU over net liabilities denominated in FCU; an importer could hedge on an excess of accounts payable denominated in FCU by entering into a contract to purchase foreign currency at a future date at a specified price.

Exposed Net Liability Position: An excess of net liabilities denominated in FCU over net assets denominated in FCU; an exporter could hedge on an excess of accounts receivable denominated in FCU by entering into a contract to sell foreign currency at a future date at a specified price.

Example 6: Forward Exchanges with Exposed Net Asset Position

Assume the same facts as in example 4 above except that on the date of the purchase, Americana contracted with the Money Exchange for the delivery of 10,000 FF in 3 months at a rate of 1 FF = $ 0.3015 (Forward Rate).

REQUIRED: Present the necessary journal entries in light of Americana's forward exchange contract with the Money Exchange

Solutions Example 6: Forward Exchanges

11/1/x1 (Date of the contract)

	Debit	Credit
Dollars Due From Broker	3,000*	
Deferred forward contract cost (.3015 -.3)(10,000) ...	15**	
Accounts payable-Money Exchange (.3015)(10,000)....		3,015

To record the purchase of the forward exchange contract and reflect the cost of the forward contract

* a valuation account (equivalent to Accounts Receivable) used to reflect the cost of 10,000 FF at a given point in time (the date of the entry)

This account is sometimes referred to a **premium on exchange contract. If the asset due from broker is less than the liability a premium exists; if the amount due from broker is greater than the liability, a **discount on exchange contract** would exist. **Under SFAS No. 52. premiums and discounts** on forward exchange contracts are normally amortized over the life of the contract. In the case of hedges on identifiable purchase commitments, premiums and discounts may be either amortized to current income or deferred and included as an adjustment to the **transaction price**. In the case of hedges on investments in foreign subsidiaries, premiums and discounts may be either amortized to current income or deferred and included as an adjustment to the amount of the **translation**.

	Debit	Credit
Equipment (10,000)(.3)..............................	3,000	
Note payable.....................................		3,000

To record the purchase at the cash equivalent price on the date of sale

12/31/x1 (Balance Sheet Date)

	Debit	Credit
Dollars Due From Broker (.32 - .30)(10,000)	200	
Exchange gain...................................		200

To adjust account to reflect current cost of 10,000 FF

	Debit	Credit
Forward Contract Expense (15)(2/3)..................	10	
Deferred Forward Contract Cost..................		10

To allocate the cost of the forward contract to the months in the current accounting period

12/31/x1 (Balance Sheet Date) Continued:

	Debit	Credit
Exchange loss (10,000)(.32-.30).....................	200	
Note payable.....................................		200

To record loss in purchasing power of the dollar due to putting off payment until 1/30/x2

1/31/x2 (Date of Payment)

Payable to Broker..................................	3,015	
Investment in FF (cost of 10,000 at current rate)...	3,300	
Dollars Due From Broker........................		3,200
Cash...		3,015
Exchange Gain..................................		100
To record payment to Money Exchange for 10,000 FF and recognition of additional gain		
Forward Contract Expense..........................	5	
Deferred Forward Contract Expense..............		5
To allocate the remaining cost of the forward contract to the current period		
Note payable (3,000 + 200)..........................	3,200	
Exchange loss (plug)................................	100	
Investment in Francs (cost of 10,000 FF @ current rate		3,300

Hedges against an exposed net liability are comparable with the exception that the hedge is for a liability denominated in FCU rather than a receivable denominated in FCU.

Hedges in excess of exposed positions: If the hedging agreement entered into by the entity is in excess of the exposed position, the excess is **accounted for as a speculative forward contract.**

Category 3: Hedges on identifiable foreign currency commitments.

An identifiable foreign currency commitment is a contract that will result in a foreign currency transaction at a future date. This differs from the situation described in Category 2 above (Forward Exchanges with Exposed Net Asset Position) in that **it is only a commitment to purchase** foreign currency and not an actual purchase. For this reason the FASB has special rules for hedges on identifiably foreign currency commitments:

a. **In General:** Gains and losses resulting from forward contracts on identifiable foreign currency commitments should be deferred and treated as an adjustment to the related foreign currency transaction if it is intended as a hedge and **both** of the following requirements are met:

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

b. **Exception:** Even if all conditions listed above are satisfied, losses should not be deferred if it is estimated that deferral would lead to recognizing cumulative transaction losses in later periods.

Hedges on identifiable foreign currency commitments: Situations Involving Special Treatment

--Certain situations that may appear to be hedges on exposed net asset or net liability positions are in fact hedges on identifiable foreign currency commitments and gains and losses should be deferred. For example if net foreign currency liabilities are to be repaid with the proceeds of an identifiable foreign currency commitment and requirement a.1. is satisfied, gains and losses on the transaction must be deferred.

--Gains or losses on forward contracts over and above amounts intended to provide hedge are deferred to the extent that the transaction provides an after tax hedge. In other words, the excess is also deferred to the extent necessary to cover after tax effects.

--Gains and losses on forward contracts over and above amounts intended to provide a hedge on an after tax basis are not deferred but are recognized in current income as exchange gains and losses;

--Gains or losses occurring after the transaction date of the commitment are not deferred but are recognized in current income as exchange gains and losses;

Example 7: Hedging an Identifiable foreign Currency Commitment

--On 11/1/x1 San Diego, Inc. contracts with TJ Ltd., a Mexican manufacturer for the delivery of 1,000 stoneware complete place settings at a cost of 72,000,000 pesos.

--The spot rate of pesos on 11/1/x1 is $.000417.

--The stoneware is to be delivered on 2/1/x2 and payment is to be made on 3/1/x2 (1 month after delivery).

--In order to hedge on the fluctuating value of the peso, San Diego purchases a 120 day forward contract to purchase 72,000,000 pesos at a forward rate of $.000400.

--The spot rate of pesos on 12/31/x1 is $.000392 and on 2/1/x2 is $.000385 and on 3/1/x2 is $.000377

--Assume that this hedge is intended as a hedge and the foreign currency transaction is designated as, and is effective as a hedge of a foreign currency commitment and the foreign currency commitment is firm.

REQUIRED: Present all necessary journal entries to reflect these events in year 19x1 and 19x2.

Solution Example 7: Hedging an Identifiable foreign Currency Commitment

Date of the Hedging Transaction (1/1/x1)

Account	Debit	Credit
Dollars due from broker (72,000,000)(.000417)....................	30,000	
Discount on forward contract (or deferred contract cost).....		1,200
Contract payable to broker (72,000,000)(.00040).............		28,800

To record the purchase of 72,000,000 pesos for delivery in 90 days (April 1, 19x1) at the forward rate

Year-end Balance Sheet Date (12/31/x1)

Account	Debit	Credit
Deferred exchange loss (72,000,000)(.000417 - .000392)...........	1,765	
Dollars due from broker.....................................		1,765

To record deferred exchange loss due to devaluation of the peso to year end. In this example the discount on the forward contract is to be deferred and treated as an adjustment of the transaction price. Refer to example 5 above to see the treatment if the amount had been amortized.

Foreign Currency Transaction Date (2/1/x2)

Account	Debit	Credit
Deferred exchange loss (72,000,000)(.000392 - .000385)..........	543	
Dollars due from broker.....................................		543

To record deferred exchange loss to the measurement date

Account	Debit	Credit
Purchases (72,000,000)(.000385)..................................	27,720	
Accounts payable..		27,720

To record the purchase at the spot rate on the transaction date

Settlement Date (3/1/x2)

Account	Debit	Credit
Contract payable to broker (72,000,000)(.00040)..................	28,800	
Cash..		28,800

To record settlement of the forward contract at the forward rate

Account	Debit	Credit
Cash (72,000,000)(.000377).......................................	27,144	
Deferred exchange loss (72,000,000)(.000385 - .000377).........	576	
Dollars due from broker (current balance)....................		27,720

To record dollar value of 72,000,000 pesos at current rate

Account	Debit	Credit
Accounts payable	27,170	
Cash..		27,170

To record payment to the Mexican company at the current dollar equivalent price

Account	Debit	Credit
Purchases	1,630	
Discount on forward contract....................................	1,200	
Deferred exchange loss (1,765 + 543 + 522).................		2,830

To reclassify the discount on the forward contract and the deferred exchange loss adjustment to the cost of the goods purchased. Recall that as an alternative approach, the discount (or premium) could have been amortized against income in the period incurred.

Category 4: Hedges on a net investment in a foreign entity.

Gains and losses resulting from foreign currency transactions **designed as and effective as** economic hedges on net investments in foreign investment entities are treated as translation adjustments (reflected in the equity section of the balance sheet with no current net income effect).
--After tax gains and losses from hedges that are treated as translation adjustments are limited in amount to the current translation adjustment from the investment.
--Discounts or premiums on these forward contracts may be combined with the translation adjustment or amortized to net income over the contract life.

IV. INCOME TAX CONSEQUENCES OF RATE CHANGES

A. Interperiod tax allocation is required in accordance with APB 11 if taxable exchange gains or tax-deductible exchange losses are included in book income in a period different than they appear in taxable income.

B. Translation adjustments should be treated as timing differences as provided in APB 11,23,24.

V. REQUIRED DISCLOSURE UNDER SFAS No. 52

--aggregate transaction gain or loss included in current net income
--analysis of changes in the Cumulative Translation Adjustment including:

1. BOY and EOY amount of cumulative translation adjustments
2. aggregate translation adjustments
3. gains and losses from hedges
4. income taxes allocated to translation adjustments
5. amounts transferred from cumulative translation adjustments to current net income as a result of sale or liquidation of a foreign investment

--rate changes subsequent to balances sheet(but Financial Statements not adjusted)

Forward Contracts Summary Table

Hedge Category:	Speculative	Hedge on net asset or net liability position	Hedge of an Identifiable Commitment	**Hedge of Net Investment in a Foreign Entity**
Purpose:	Investment	Eliminate Gains/losses resulting from exchange rate changes	lock-in purchase or sales prices of goods that must be paid for in foreign currency	Eliminate fluctuations in net value of the investment due to exchange rate changes
Type of Adjustment:	Remeasurement	Remeasurement	Remeasurement	Translation
Statement on which are reported	Income Statement	Income Statement	Income Statement	Balance Sheet
Treatment of Gains	Recognize currently in net income	Recognize currently in net income	Deferred until transaction date	Adjustment to the translation adjustment in the equity section of the balance sheet
Treatment of Premiums/Discounts (Deferred Exp)	N/A	Amortize ratably over life of forward contract	Amortize ratably over life of forward contract OR defer and treat as an adjustment of purchase/sales price	Amortize ratably over life of forward contract OR defer and treat as an adjustment of translation adjustment in the equity section of the balance sheet

Summary of Translation/Remeasurement Effects

The Following Items are Included in the Cumulative Consolidated Translation Adjustment:

1. All adjustments between the subsidiaries functional currency and the US$ (Parent's reporting currency);
2. Exchange gains and losses on transactions both designated as and effective as hedges in net investments in a foreign entity;
3. Exchange gains and losses in intercompany foreign currency transactions on long-term investments;

The Following Items are Included in the Consolidated Income Statement (Remeasurement Adjustments):

1. Net exchange gains/losses on foreign currency transactions;
2. Net exchange gains/losses on hedges of foreign currency transactions;
3. That portion of exchange gains/losses on hedges of identifiable foreign currency commitments:

--amounts in **excess** of a hedge of the commitment on an after tax basis.

--the entire amount of the hedge made **after** the transaction date.

4. Income or expenses resulting from foreign currency contracts (optionally include hedges of identifiable commitments);
5. Exchange gains and losses on speculative forward contracts;
6. Cumulative translation adjustments when the foreign subsidiary is sold or substantially liquidated;
7. If the foreign subsidiary operates in a "highly inflationary economy", all effects between the US$ and the functional currency (that would ordinarily be translations) are reported on the income statement;
8. If the foreign subsidiary keeps its books in any "other foreign currency", all adjustments between that other foreign currency and the functional currency go to the income statement;

The Following Items are Deferred and Treated as Adjustments to the Related Foreign Currency Transaction (if they are intended as hedges and the foreign currency commitment is firm)

1. Exchange gains/losses on hedges of identifiable foreign currency commitments up to the transaction date
2. optional: deferred contract premium/discount of hedges of identifiable foreign currency commitments