Question 1
L2R20TB-AC039-1512
LOS: LOS-7040
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium

BigCo is a U.S.-based multinational operating multiple economically viable subsidiaries (positive stockholder equity) in stable economies. BigCo complies with IFRS. It states in the MD&A section of its most recent annual report: "The local currency is the functional currency for almost all our foreign operations."

The MD&A in this section goes on to make the following three statements:

1. The foreign currency statements of income are translated into U.S. dollars at prevailing market rates.
2. To the extent the U.S. dollar weakens against foreign currency, the translated statements of income will reflect reduced revenue.
3. The gains or losses resulting from foreign currency risk are captured in other comprehensive income which is part of stockholders' equity.

Which statement included in BigCo's MD&A is *least likely* to be accurate?

- ○ Statement 1.
- ● Statement 2.
- ○ Statement 3.

Rationale
✗ **Statement 1.**
The first sentence of the MD&A states that the functional currency is the local (foreign) currency, not the parent's presentation currency. Therefore, the current rate method is applied. Statements 1 and 3 are correct under the current rate method. Statement 2 is incorrect. If the U.S. dollar weakens, then the foreign currency is strengthening which would increase revenue in the translated statements.

Rationale
✓ **Statement 2.**
The first sentence of the MD&A states that the functional currency is the local (foreign) currency, not the parent's presentation currency. Therefore, the current rate method is applied. Statements 1 and 3 are correct under the current rate method. Statement 2 is incorrect. If the U.S. dollar weakens, then the foreign currency is strengthening which would increase revenue in the translated statements.

Rationale
✗ **Statement 3.**
The first sentence of the MD&A states that the functional currency is the local (foreign) currency, not the parent's presentation currency. Therefore, the current rate method is applied. Statements 1 and 3 are correct under the current rate method. Statement 2 is incorrect. If the U.S. dollar weakens, then the foreign currency is strengthening which would increase revenue in the translated statements.

Question 2

L2FR-TB0022-1412

LOS: LOS-7060

Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure

Difficulty: medium

A multinational company has a presentation currency that has been strengthening steadily over recent years, while at the same time a subsidiary has experienced a prolonged period of stagnant sales in its local currency. During this period the translated sales of the subsidiary will *most likely* have been:

- ○ Falling under the temporal method but constant under the current method.
- ○ Constant under the temporal method but falling under the current method.
- ◉ Falling under both the temporal method and the current method.

Rationale

This Answer is Correct

Sales are converted at the average rate for the relevant period under both the temporal method and the current method. Since the presentation currency is strengthening, the foreign currency will be weakening leading to lower sales in the presentation currency under both methods.

Question 3
L2R20TB-ITEMSET-AC035-1512
LOS: LOS-7090
LOS: LOS-7130
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium

Use the following information to answer the next two questions:

i.
When a multinational determines the functional currency of its foreign operations to be the foreign currency, which financial ratio after translation is consistent in its relationship with the local currency financial statements?

- (selected) Gross profit percentage.
- Receivables turnover.
- Return on equity.

Rationale

This Answer is Correct

If the functional currency is the foreign currency, the current rate method is applied. Under the current rate method many financial ratios hold the same relationship before and after translation if both the numerator and denominator are from the same financial statement (and translated at the same exchange rate). The only ratio that meets this criterion is the gross profit margin. In contrast, the receivables turnover uses a mix of current rates (accounts receivable) and average rates (revenue) and the return on equity uses a mix of historical rates (equity) and average rates (net income).

Rationale

This Answer is Correct

If the functional currency is the foreign currency, the current rate method is applied. Under the current rate method many financial ratios hold the same relationship before and after translation if both the numerator and denominator are from the same financial statement (and translated at the same exchange rate). The only ratio that meets this criterion is the gross profit margin. In contrast, the receivables turnover uses a mix of current rates (accounts receivable) and average rates (revenue) and the return on equity uses a mix of historical rates (equity) and average rates (net income).

Rationale

This Answer is Incorrect

If the functional currency is the foreign currency, the current rate method is applied. Under the current rate method many financial ratios hold the same relationship before and after translation if both the numerator and denominator are from the same financial statement (and translated at the same exchange rate). The only ratio that meets this criterion is the gross profit margin. In contrast, the receivables turnover uses a mix of current rates (accounts receivable) and average rates (revenue) and the return on equity uses a mix of historical rates (equity) and average rates (net income).

ii.
If the functional currency of a foreign operation using the LIFO method is the same as the parent's presentation currency, and the foreign currency is appreciating, as compared to using the local currency as the functional currency, the translated statements will *most likely* show a lower:

- (selected) current ratio.

- operating profit margin.
- debt-to-total assets ratio.

Rationale

This Answer is Incorrect

If the functional currency is the parent's presentation currency, the temporal method is applied. Under the temporal method the current ratio (current assets / current liabilities) is lower after translation than the local currency statements when the foreign currency is appreciating because inventory in the numerator is translated at historical exchange rates which would be lower than current rates.

The operating profit margin and debt-to-total assets ratio rise after translation when the foreign currency is appreciating and the temporal method is used. Operating profit margin rises because revenues are translated at the average rate, but some of the foreign operation's expenses (depreciation, etc.) are translated at lower historical rates. As a result of this mismatch, the operating profit increases faster due to translation than revenues and a higher operating profit margin results. The debt-to- total asset ratio rises because debt, the numerator, is translated at the higher current rate but the denominator which includes non-monetary assets is translated using lower historical rates. The net result is that the ratio rises.

Rationale

This Answer is Incorrect

If the functional currency is the parent's presentation currency, the temporal method is applied. Under the temporal method the current ratio (current assets / current liabilities) is lower after translation than the local currency statements when the foreign currency is appreciating because inventory in the numerator is translated at historical exchange rates which would be lower than current rates.

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Rationale

This Answer is Incorrect

If the functional currency is the parent's presentation currency, the temporal method is applied. Under the temporal method the current ratio (current assets / current liabilities) is lower after translation than the local currency statements when the foreign currency is appreciating because inventory in the numerator is translated at historical exchange rates which would be lower than current rates.

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translation than revenues and a higher operating profit margin results. The debt-to- total asset ratio rises because debt, the numerator, is translated at the higher current rate but the denominator which includes non-monetary assets is translated using lower historical rates. The net result is that the ratio rises.

Question 4
L2R20TB-AC017-1512
LOS: LOS-7080
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium

SubCo, a foreign subsidiary of ParentCo, has a net liability balance sheet exposure as of its fiscal year end, December 31, 20X0. SubCo has a positive stockholders' equity. Spot exchange rates for ParentCo's presentation currency (PC$) per one local currency unit of SubCo are listed below:

January 1, 20X0	PC$0.80 = 1LC
Average 20X0	PC$0.75 = 1LC
December 31, 20X0	PC$0.70 = 1LC

ParentCo *most likely* will report the translation:

- ○ loss in the income statement.
- ◉ gain in the income statement.
- ○ gain as a component of stockholders' equity.

Rationale

✗ loss in the income statement.

The foreign currency is depreciating and there is a net liability balance sheet exposure which implies a gain—the liability position when converted to PC$ is declining, even if is it not declining in LC units. We can assume the temporal method is used because of the net liability balance sheet exposure; under the current rate method, unless a company has negative stockholders' equity, it will have a net asset balance sheet exposure.

Rationale

✓ gain in the income statement.

The foreign currency is depreciating and there is a net liability balance sheet exposure which implies a gain—the liability position when converted to PC$ is declining, even if is it not declining in LC units. We can assume the temporal method is used because of the net liability balance sheet exposure; under the current rate method, unless a company has negative stockholders' equity, it will have a net asset balance sheet exposure.

Rationale

✗ gain as a component of stockholders' equity.

The foreign currency is depreciating and there is a net liability balance sheet exposure which implies a gain—the liability position when converted to PC$ is declining, even if is it not declining in LC units. We can assume the temporal method is used because of the net liability balance sheet exposure; under the current rate method, unless a company has negative stockholders' equity, it will have a net asset balance sheet exposure.

Question 5
L2R20TB-AC021-1512
LOS: LOS-7100
Lesson Reference: Lesson 3: Translation of Foreign Currency Financial Statements: Hyperinflationary Economies
Difficulty: medium
SubCo is a foreign subsidiary operating in a highly inflationary economy. SubCo's parent is a U.S.-based holding company that complies with U.S. GAAP. In the most recent year, the inflation rate where SubCo operates was 100 percent. SubCo's notes payable in the translated statements *most likely* will:

- ○ Be restated for inflation and translated at historical exchange rates.
- ◉ Not be adjusted for inflation and translated at current exchange rates.
- ○ Not be adjusted for inflation and translated at historical exchange rates.

Rationale
✗ **Be restated for inflation and translated at historical exchange rates.**
U.S. GAAP does not allow for the restatement to adjust for inflation when translating foreign currency statements; instead U.S. GAAP requires the temporal method be used. Under the temporal method, notes payable (and other monetary liabilities) are translated at the current exchange rate.

Rationale
✓ **Not be adjusted for inflation and translated at current exchange rates.**
U.S. GAAP does not allow for the restatement to adjust for inflation when translating foreign currency statements; instead U.S. GAAP requires the temporal method be used. Under the temporal method, notes payable (and other monetary liabilities) are translated at the current exchange rate.

Rationale
✗ **Not be adjusted for inflation and translated at historical exchange rates.**
U.S. GAAP does not allow for the restatement to adjust for inflation when translating foreign currency statements; instead U.S. GAAP requires the temporal method be used. Under the temporal method, notes payable (and other monetary liabilities) are translated at the current exchange rate.

Question 6
L2FR-PQ1928-1410
LOS: LOS-7070
LOS: LOS-7080
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
Until recently, a parent company classified its presentation currency as the functional currency when classifying a foreign subsidiary's financial statements. It now classifies the foreign subsidiary's local currency as the functional currency. This change will *most likely* result in which of the following now being recognized on the parent's financial statements?

- (selected) Unrealized gains and losses on nonmonetary assets and liabilities
- Unrealized gains and losses on monetary assets and liabilities
- Realized gains and losses on nonmonetary assets and liabilities

Rationale

This Answer is Correct

Under the temporal method (which was previously in effect) unrealized gains and losses on monetary assets and liabilities are recognized in the financial statements as balance sheet exposure for the parent equals the net monetary asset position in the foreign subsidiary. Once the switch to the current rate method is made, balance sheet exposure now equals the net asset position in the subsidiary (monetary and nonmonetary assets).

Question 7
L2R20TB-AC014-1512
LOS: LOS-7130
Lesson Reference: Lesson 4: Multinational Operations and the Company’s Effective Tax Rate and Foreign Currency–Related Disclosures
Difficulty: medium
In a period where the parent's currency is appreciating relative to the foreign currency and the subsidiary's functional currency is the parent's presentation currency, the translated current ratio relative to the current ratio using the local currency financial statements *most likely* will be:

- Lower.
- Higher.
- The same.

Rationale

Lower.

If the subsidiary's functional currency is the parent's presentation currency, then the temporal method is used. Under the temporal method, monetary assets and liabilities are translated at the current exchange rate, but non-monetary assets (including inventory) are translated historical rates. If the parent's currency is appreciating, then the translated current ratio will have a higher change in its numerator than its denominator and this causes the translated current ratio to be higher. This is best seen by doing the calculations using assumed numbers.

Assume the subsidiary's current assets are FC1 million in cash and FC4 million in inventory and its current liabilities are FC5 million. In FC, the current ratio is 1.0 [(1 + 4)/5]. Also assume that the historical exchange rate that applies to inventories is $1 = FC1 and the current exchange rate is $1 = FC2 (dollar is appreciating). Under the temporal method, the FC1 million in cash is translated at the current exchange rate into $500,000 (FC1 million × $1/2FC) and the FC4 million in inventory is translated at the historical rate into $4 million (FC4 million × $1/FC1). The current liabilities of FC5 million are translated at the current exchange rate into $2,500,000 (FC5 million × $1/2FC). In dollars, the current ratio is 1.8 [($500,000 + $4 million)/$2.5 million]. Thus, the ratio rose.

Rationale

Higher.

If the subsidiary's functional currency is the parent's presentation currency, then the temporal method is used. Under the temporal method, monetary assets and liabilities are translated at the current exchange rate, but non-monetary assets (including inventory) are translated historical rates. If the parent's currency is appreciating, then the translated current ratio will have a higher change in its numerator than its denominator and this causes the translated current ratio to be higher. This is best seen by doing the calculations using assumed numbers.

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$2,500,000 (FC5 million × $1/2FC). In dollars, the current ratio is 1.8 [($500,000 + $4 million)/$2.5 million]. Thus, the ratio rose.

Rationale

The same.

If the subsidiary's functional currency is the parent's presentation currency, then the temporal method is used. Under the temporal method, monetary assets and liabilities are translated at the current exchange rate, but non-monetary assets (including inventory) are translated historical rates. If the parent's currency is appreciating, then the translated current ratio will have a higher change in its numerator than its denominator and this causes the translated current ratio to be higher. This is best seen by doing the calculations using assumed numbers.

Assume the subsidiary's current assets are FC1 million in cash and FC4 million in inventory and its current liabilities are FC5 million. In FC, the current ratio is 1.0 [(1 + 4)/5]. Also assume that the historical exchange rate that applies to inventories is $1 = FC1 and the current exchange rate is $1 = FC2 (dollar is appreciating). Under the temporal method, the FC1 million in cash is translated at the current exchange rate into $500,000 (FC1 million × $1/2FC) and the FC4 million in inventory is translated at the historical rate into $4 million (FC4 million × $1/FC1). The current liabilities of FC5 million are translated at the current exchange rate into $2,500,000 (FC5 million × $1/2FC). In dollars, the current ratio is 1.8 [($500,000 + $4 million)/$2.5 million]. Thus, the ratio rose.

Question 8

L200-PQ0014-1412

LOS: LOS-7130

Lesson Reference: Lesson 4: Multinational Operations and the Company's Effective Tax Rate and Foreign Currency–Related Disclosures

Difficulty: medium

If the net sales growth for U.S.-based Global Telecommunications in Germany was 8% for the past year and the local currency rose 2% in value relative to the domestic currency, what is the organic growth rate?

- ○ 8%
- ◉ 6%
- ○ 10%

Rationale

This Answer is Correct

The organic (or domestic) rate of growth for Global Telecommunications in Germany is 6%. This is the net of local sales and currency fluctuations, which moved against the company by 2%.

Question 9
L2R20TB-AC011-1512
LOS: LOS-7070
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
A parent company is using the current rate method to consolidate the results of a subsidiary operating in a foreign country. During the period, the parent's currency has been depreciating relative to the foreign currency. If the parent was using the temporal method, the consolidated fixed assets would *most likely* be:

- (selected) lower.
- higher.
- the same.

Rationale
lower. (correct)
Under the current rate method all assets are translated at the current exchange rate, while the temporal method requires non-monetary assets, such as fixed assets, be translated at historical rates. The parent company's currency has been depreciating, so the parent's currency buys less of the foreign currency. Assume that the subsidiary bought FC2.0 million of fixed assets two years ago and that the exchange rate then was FC1 = $1 (the parent's reporting currency). Two years later, the fixed assets have fallen to FC1.5 million as a result of depreciation and the current exchange rate is FC1 = $2. Under the current rate method, the translated value of subsidiary's fixed assets in the parent company's currency is $3.0 million (FC1.5 million × $2/FC1). In comparison, the temporal method will result $1.5 million (FC1.5 million × $1/FC1) in fixed assets being added in the consolidation because the historical rate is used. Therefore, under the temporal method, the consolidated fixed assets will be lower than they will be under the current rate method.

Rationale
higher. (incorrect)
Under the current rate method all assets are translated at the current exchange rate, while the temporal method requires non-monetary assets, such as fixed assets, be translated at historical rates. The parent company's currency has been depreciating, so the parent's currency buys less of the foreign currency. Assume that the subsidiary bought FC2.0 million of fixed assets two years ago and that the exchange rate then was FC1 = $1 (the parent's reporting currency). Two years later, the fixed assets have fallen to FC1.5 million as a result of depreciation and the current exchange rate is FC1 = $2. Under the current rate method, the translated value of subsidiary's fixed assets in the parent company's currency is $3.0 million (FC1.5 million × $2/FC1). In comparison, the temporal method will result $1.5 million (FC1.5 million × $1/FC1) in fixed assets being added in the consolidation because the historical rate is used. Therefore, under the temporal method, the consolidated fixed assets will be lower than they will be under the current rate method.

Rationale
the same. (incorrect)
Under the current rate method all assets are translated at the current exchange rate, while the temporal method requires non-monetary assets, such as fixed assets, be translated at historical rates. The parent company's currency has been depreciating, so the parent's currency buys less of the foreign currency. Assume that the subsidiary bought FC2.0 million of fixed assets two years ago and that the exchange rate

then was FC1 = $1 (the parent's reporting currency). Two years later, the fixed assets have fallen to FC1.5 million as a result of depreciation and the current exchange rate is FC1 = $2. Under the current rate method, the translated value of subsidiary's fixed assets in the parent company's currency is $3.0 million (FC1.5 million × $2/FC1). In comparison, the temporal method will result $1.5 million (FC1.5 million × $1/FC1) in fixed assets being added in the consolidation because the historical rate is used. Therefore, under the temporal method, the consolidated fixed assets will be lower than they will be under the current rate method.

Question 10

L2R20TB-AC026-1512

LOS: LOS-7070

Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods

Difficulty: medium

A multinational reports translation gains and losses of its foreign operations in net income; the translated financial statements *most likely* will translate operating expenses using the:

- (selected) average rate for the period.
- rate in effect at the end of the reporting period.
- rate in effect at the beginning of the reporting period.

Rationale

✓ **average rate for the period.**

If translation gains and losses are reported in the income statement, the temporal method is applied. Under the temporal method (and the current rate method) most operating expenses are translated at the average rate for the period.

Rationale

✗ **rate in effect at the end of the reporting period.**

If translation gains and losses are reported in the income statement, the temporal method is applied. Under the temporal method (and the current rate method) most operating expenses are translated at the average rate for the period.

Rationale

✗ **rate in effect at the beginning of the reporting period.**

If translation gains and losses are reported in the income statement, the temporal method is applied. Under the temporal method (and the current rate method) most operating expenses are translated at the average rate for the period.

Question 11
L2FR-PQ1930-1410
LOS: LOS-7070
LOS: LOS-7080
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
In which of the following circumstances should a parent apply the temporal method to translate a foreign subsidiary's financial statements?

- ○ When the subsidiary's operating, financing, and investing decisions are made independently from the parent.
- ● When the subsidiary and the parent are well integrated.
- ○ When exchange rate movements over the period would result in a translation gain for the parent.

Rationale

This Answer is Correct

The temporal method should be applied when the activities of the parent and the sub are well-integrated.

The current rate method should be applied when the subsidiary's operating, financing, and investing decisions are made independently from the parent.

The translation method should not be chosen based on whether it results in a translation gain or loss for the parent.

Question 12
L2FR-TB0020-1412
LOS: LOS-7040
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium
A German company which has a fully owned Swiss subsidiary that uses the euro in its day-to-day operations will have:

- ○ The Swiss franc as functional currency and euro as presentation currency.
- ◉ The euro as both the functional and presentation currency.
- ○ The euro as functional currency and the Swiss franc as presentation currency.

Rationale

This Answer is Correct

The functional currency of a subsidiary is the currency of the primary market in which the entity operates, which in this case would likely be the euro. The presentation currency is always the currency of the parent company.

Question 13
L2R20TB-AC025-1512
LOS: LOS-7130
Lesson Reference: Lesson 4: Multinational Operations and the Company’s Effective Tax Rate and Foreign Currency–Related Disclosures
Difficulty: medium
Assume the parent's presentation currency is the functional currency for a foreign subsidiary and the foreign currency is appreciating. In comparison to the local currency financial statements, the translated financial statements will show a debt-to-total assets ratio that is *most likely*:

- ○ Lower.
- ◉ Higher.
- ○ The same.

Rationale
Lower.
If the parent's presentation currency is the functional currency then the temporal method is applied. The debt-to-asset ratio most likely will be higher if the foreign currency is appreciating. Monetary liabilities, of which the majority of debt is generally comprised, are translated at current rates; assets are translated at a mix of current and historical rates. If the foreign currency is appreciating, the historical rates will be lower, making the denominator (assets) lower, resulting in a higher ratio in comparison with the local currency statements.

Rationale
Higher.
If the parent's presentation currency is the functional currency then the temporal method is applied. The debt-to-asset ratio most likely will be higher if the foreign currency is appreciating. Monetary liabilities, of which the majority of debt is generally comprised, are translated at current rates; assets are translated at a mix of current and historical rates. If the foreign currency is appreciating, the historical rates will be lower, making the denominator (assets) lower, resulting in a higher ratio in comparison with the local currency statements.

Rationale
The same.
If the parent's presentation currency is the functional currency then the temporal method is applied. The debt-to-asset ratio most likely will be higher if the foreign currency is appreciating. Monetary liabilities, of which the majority of debt is generally comprised, are translated at current rates; assets are translated at a mix of current and historical rates. If the foreign currency is appreciating, the historical rates will be lower, making the denominator (assets) lower, resulting in a higher ratio in comparison with the local currency statements.

Question 14
L2FR-TB0025-1412
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
A company has a subsidiary in a country that is experiencing a weakening currency environment. Even though its debt to equity ratio is low, the subsidiary's monetary liabilities are greater than its monetary assets.The debt-to-equity ratio of the subsidiary in the presentation currency will most likely be:

- (selected) Lower under the temporal method.
- Lower under the current method.
- The same for both the temporal method and the current method.

Rationale

This Answer is Correct

Current method: The company has positive net assets (as D/E ratio is low) in a weakening currency environment causing a foreign exchange loss in the cumulative translation adjustment account. This results in *lower* equity.

Temporal method: The company has negative net monetary assets and, in a weakening currency environment, this will cause a foreign exchange gain in the income statement. This results in *higher* equity.

Temporal method will have a lower D/E ratio due to higher equity in the denominator.

Question 15
L2R20TB-AC020-1512
LOS: LOS-7100
Lesson Reference: Lesson 3: Translation of Foreign Currency Financial Statements: Hyperinflationary Economies
Difficulty: medium
A European holding company operates a foreign subsidiary in a highly inflationary economy. In complying with IFRS, the holding company *most likely* will translate accounts receivables on the inflation-adjusted financial statements using the:

- Average rate for the period.
- Rate in effect at the transaction date.
- Rate in effect at the end of the reporting period.

Rationale
Average rate for the period.
IFRS requires foreign currency statements of foreign operations in highly inflationary environments first be restated for local inflation and then translated using the current exchange rate.

Rationale
Rate in effect at the transaction date.
IFRS requires foreign currency statements of foreign operations in highly inflationary environments first be restated for local inflation and then translated using the current exchange rate.

Rationale
Rate in effect at the end of the reporting period.
IFRS requires foreign currency statements of foreign operations in highly inflationary environments first be restated for local inflation and then translated using the current exchange rate.

Question 16
L2R20TB-AC008-1512
LOS: LOS-7050
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium

Diggs, a U.S. company, purchases €100,000 of goods from a European manufacturer on November 30, 20X2; payment is due in 90 days payable in euros. Diggs' fiscal year-end is December 31, 20X2. Relevant spot exchange rates are listed below:

November 30, 20X2	€1 = $1.298
December 31, 20X2	€1 = $1.319
February 28, 20X3	€1 = $1.307

Diggs pays in full on February 28, 20X3. The amount of foreign currency gain or loss that Diggs will record in 20X3 is *closest to* a:

- $1,200 loss.
- $1,200 gain.
- $900 loss.

Rationale
$1,200 loss.
When the balance sheet date falls between transaction inception and transaction closing, a foreign currency gain or loss must be recorded at the fiscal year-end and another foreign currency gain or loss is recorded for the period from the fiscal year-end through the transaction closing date. Diggs has a liability exposure and between December 31, 20X2 and February 28, 20X3 the foreign currency (euro) depreciated (the amount of dollars that Diggs will need to buy euros to pay off the payable has declined); this results in a gain. The amount of foreign currency gain to be recorded in 20X3 is $1,200 [($1.307 – 1.319) × €100,000 liability]. In the 20X2 year-end financial statements, Diggs will have a foreign currency loss because the euro strengthened between the transaction inception and December 31. The loss will equal $2,100 [($1.319 – 1.298) × €100,000 liability]. The transaction has an actual realized loss of $900 from inception through close.

Rationale
$1,200 gain.
When the balance sheet date falls between transaction inception and transaction closing, a foreign currency gain or loss must be recorded at the fiscal year-end and another foreign currency gain or loss is recorded for the period from the fiscal year-end through the transaction closing date. Diggs has a liability exposure and between December 31, 20X2 and February 28, 20X3 the foreign currency (euro) depreciated (the amount of dollars that Diggs will need to buy euros to pay off the payable has declined); this results in a gain. The amount of foreign currency gain to be recorded in 20X3 is $1,200 [($1.307 – 1.319) × €100,000 liability]. In the 20X2 year-end financial statements, Diggs will have a foreign currency loss because the euro strengthened between the transaction inception and December 31. The loss will equal $2,100 [($1.319 – 1.298) × €100,000 liability]. The transaction has an actual realized loss of $900 from inception through close.

Rationale

$900 loss.

When the balance sheet date falls between transaction inception and transaction closing, a foreign currency gain or loss must be recorded at the fiscal year-end and another foreign currency gain or loss is recorded for the period from the fiscal year-end through the transaction closing date. Diggs has a liability exposure and between December 31, 20X2 and February 28, 20X3 the foreign currency (euro) depreciated (the amount of dollars that Diggs will need to buy euros to pay off the payable has declined); this results in a gain. The amount of foreign currency gain to be recorded in 20X3 is $1,200 [($1.307 – 1.319) × €100,000 liability]. In the 20X2 year-end financial statements, Diggs will have a foreign currency loss because the euro strengthened between the transaction inception and December 31. The loss will equal $2,100 [($1.319 – 1.298) × €100,000 liability]. The transaction has an actual realized loss of $900 from inception through close.

Question 17
L2R20TB-AC016-1512
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
An analyst is overheard discussing the difficulties in analysis because of the distortions created by foreign currency translations. He is *most likely* to be overheard saying: “The current rate method is inconsistent in its use of exchange rates distorting the ratios of the local currency statements, particularly with regard to:

- ○ gross profit margin.”
- ◉ inventory turnover.”
- ○ interest coverage.”

Rationale

✖ **gross profit margin.”**

Although inventory turnover is consistent between the current rate method and the temporal method, it is not consistent with local currency statements and uses inconsistent exchanges rates in its numerator and denominator. Under the current rate method, inventory is translated at current exchange rates and cost of sales is translated at average rates, distorting the relationship relative to local currency statements. Gross profit margin and interest coverage ratios are derived from the income statement and maintain the relationship with local currency statements.

Rationale

✔ **inventory turnover.”**

Although inventory turnover is consistent between the current rate method and the temporal method, it is not consistent with local currency statements and uses inconsistent exchanges rates in its numerator and denominator. Under the current rate method, inventory is translated at current exchange rates and cost of sales is translated at average rates, distorting the relationship relative to local currency statements. Gross profit margin and interest coverage ratios are derived from the income statement and maintain the relationship with local currency statements.

Rationale

✖ **interest coverage.”**

Although inventory turnover is consistent between the current rate method and the temporal method, it is not consistent with local currency statements and uses inconsistent exchanges rates in its numerator and denominator. Under the current rate method, inventory is translated at current exchange rates and cost of sales is translated at average rates, distorting the relationship relative to local currency statements. Gross profit margin and interest coverage ratios are derived from the income statement and maintain the relationship with local currency statements.

Question 18
L2R20TB-AC037-1512
LOS: LOS-7080
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
If a foreign subsidiary's translation gains and losses are reported on the holding company's income statement, the holding company is *least likely* to decrease a balance sheet liability exposure to current exchange rates by:

- (selected) purchasing new equipment financed with debt.
- paying off trade payables with cash.
- selling equipment for cash.

Rationale
✔ **purchasing new equipment financed with debt.**
If a multinational reports gains and losses on its income statement, it applies the temporal method. In order to reduce a balance sheet liability exposure, monetary assets need to increase and/or monetary liabilities need to decrease under the temporal method. Purchasing new equipment financed with debt is least likely to decrease liability exposure because non-monetary assets (non-impact) increase and monetary liabilities increase. Hence, this option will increase the balance sheet liability exposure.

Rationale
✘ **paying off trade payables with cash.**
If a multinational reports gains and losses on its income statement, it applies the temporal method. In order to reduce a balance sheet liability exposure, monetary assets need to increase and/or monetary liabilities need to decrease under the temporal method. Purchasing new equipment financed with debt is least likely to decrease liability exposure because non-monetary assets (non-impact) increase and monetary liabilities increase. Hence, this option will increase the balance sheet liability exposure.

Rationale
✘ **selling equipment for cash.**
If a multinational reports gains and losses on its income statement, it applies the temporal method. In order to reduce a balance sheet liability exposure, monetary assets need to increase and/or monetary liabilities need to decrease under the temporal method. Purchasing new equipment financed with debt is least likely to decrease liability exposure because non-monetary assets (non-impact) increase and monetary liabilities increase. Hence, this option will increase the balance sheet liability exposure.

Question 19
L200-PQ0013-1412
LOS: LOS-7120
Lesson Reference: Lesson 4: Multinational Operations and the Company's Effective Tax Rate and Foreign Currency–Related Disclosures
Difficulty: medium
Forecasting future performance as sales growth is arguably more sustainable when estimates are not based on which of the following?

- Prices.
- Volumes.
- Foreign exchange rates.

Rationale

This Answer is Correct

Forecasting future performance as sales growth that comes from changes in prices and volumes is arguably more sustainable than growth from exchange rate movements.

Question 20
L2R20TB-AC024-1512
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
A foreign subsidiary uses its local currency as its functional currency. In comparison to the local currency financial statements, the translated financial statements will show a different:

- current ratio.
- operating profit margin.
- receivables turnover ratio.

Rationale
current ratio.
The current ratio and the operating profit margin will be the same whether determined in local currency or after translation under the current rate method (foreign currency is the functional currency). The receivables turnover ratio compares revenue translated at an average rate and accounts receivable translated at the current rate creating a different receivable turnover ratio after translation than is determined in the local currency.

Rationale
operating profit margin.
The current ratio and the operating profit margin will be the same whether determined in local currency or after translation under the current rate method (foreign currency is the functional currency). The receivables turnover ratio compares revenue translated at an average rate and accounts receivable translated at the current rate creating a different receivable turnover ratio after translation than is determined in the local currency.

Rationale
receivables turnover ratio.
The current ratio and the operating profit margin will be the same whether determined in local currency or after translation under the current rate method (foreign currency is the functional currency). The receivables turnover ratio compares revenue translated at an average rate and accounts receivable translated at the current rate creating a different receivable turnover ratio after translation than is determined in the local currency.

Question 21
L2R20TB-AC023-1512
LOS: LOS-7070
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
An analyst reviews the MD&A of a European-based multinational with several foreign operations, all operating in stable, non-inflationary economies. She highlights the following excerpts: "… Although our foreign operations report in local currency; we assign the parent's presentation currency (euro) as the subsidiaries' functional currency. We feel it is important to note that regarding our largest subsidiary, SubCo, if the euro appreciates against SubCo's local currency, we have to recognize a translation loss in the consolidated profit and loss statement." SubCo is *most likely* translated using the:

- current rate method and has a net monetary asset exposure.
- temporal method and has a net monetary liability exposure.
- (selected) temporal method and has a net monetary asset exposure.

Rationale

✗ current rate method and has a net monetary asset exposure.

If the parent's presentation currency is the functional currency then the temporal method is applied, which is further confirmed by the statement that translation losses are recognized in the profit and loss statement. It is indicated that if the euro appreciates (foreign currency depreciates), a translation loss is recognized. If the foreign currency is depreciating, a net monetary asset balance sheet exposure results in a translation loss.

Rationale

✗ temporal method and has a net monetary liability exposure.

If the parent's presentation currency is the functional currency then the temporal method is applied, which is further confirmed by the statement that translation losses are recognized in the profit and loss statement. It is indicated that if the euro appreciates (foreign currency depreciates), a translation loss is recognized. If the foreign currency is depreciating, a net monetary asset balance sheet exposure results in a translation loss.

Rationale

✓ temporal method and has a net monetary asset exposure.

If the parent's presentation currency is the functional currency then the temporal method is applied, which is further confirmed by the statement that translation losses are recognized in the profit and loss statement. It is indicated that if the euro appreciates (foreign currency depreciates), a translation loss is recognized. If the foreign currency is depreciating, a net monetary asset balance sheet exposure results in a translation loss.

Question 22
L2R20TB-AC019-1512
LOS: LOS-7060
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium

A British holding company translates the year ending 20X2 foreign currency financial statements of its German subsidiary. The spot exchange rates for the British pound per euro are:

January 1, 20X2	£0.80 per euro
Average 20X2	£0.83 per euro
December 31, 20X2	£0.85 per euro

If the functional currency of the subsidiary is the euro, and the trend in exchange rates is expected to continue, translated revenue and total assets would be expected to:

- increase and decrease, respectively.
- both decrease.
- both increase.

Rationale
increase and decrease, respectively.
In this scenario the foreign currency is strengthening. If the subsidiary's functional currency is the euro (the foreign currency), the current rate method is used and translated revenue and total assets would both be higher. Revenue is translated at an average rate and assets are translated at the current rate, with both of these rates being expected to increase over time if the foreign currency is appreciating.

Rationale
both decrease.
In this scenario the foreign currency is strengthening. If the subsidiary's functional currency is the euro (the foreign currency), the current rate method is used and translated revenue and total assets would both be higher. Revenue is translated at an average rate and assets are translated at the current rate, with both of these rates being expected to increase over time if the foreign currency is appreciating.

Rationale
both increase.
In this scenario the foreign currency is strengthening. If the subsidiary's functional currency is the euro (the foreign currency), the current rate method is used and translated revenue and total assets would both be higher. Revenue is translated at an average rate and assets are translated at the current rate, with both of these rates being expected to increase over time if the foreign currency is appreciating.

Question 23
L2R20TB-AC015-1512
LOS: LOS-7130
Lesson Reference: Lesson 4: Multinational Operations and the Company’s Effective Tax Rate and Foreign Currency–Related Disclosures
Difficulty: medium
In a period where the parent's currency is depreciating relative to the foreign currency and the subsidiary's functional currency is not the parent's presentation currency, the translated inventory turnover ratio (based on only ending inventory) relative to the inventory turnover ratio (based on only ending inventory) using the local currency financial statements *most likely* will be:

- (selected) Lower.
- Higher.
- The same.

Rationale
Lower.

The inventory turnover is calculated as cost of sales/average inventory, but the question states that only ending inventory is to be used in the ratio. If the subsidiary's functional currency is not the parent's presentation currency, then the current rate method is applied. Under the current rate method, inventory is translated at the current exchange rate and the cost of sales expense is translated at the average exchange rate for the period. If the parent's currency is depreciating, then the translated inventory turnover ratio will have a lower change in its numerator than its denominator and this causes the translated inventory turnover to be lower. This is best seen by doing the calculations using assumed numbers.

Assume that subsidiary's ending inventory is FC4 million and its cost of sales equals FC40 million. In FC, the inventory turnover is 10.0 (40/4). Also assume that the parent's reporting currency is dollars and that the average exchange rate for the period, which is applied to cost of sales, is $1 = FC1.1 and the current exchange rate, which is applied to the inventory, is $1 = FC1.0 (note that the dollar is depreciating; it buys less FC by the end of the year). The inventory of FC4 million is translated into $4 million (FC4 million × $1/FC1) and the cost of sales amount of FC 40 million is translated into $36.36 million (FC40 million × $1/1.1FC). In dollars, the inventory turnover is 9.1 ($36.36 million/$4 million). Thus, the inventory turnover ratio fell.

Rationale
Higher.

The inventory turnover is calculated as cost of sales/average inventory, but the question states that only ending inventory is to be used in the ratio. If the subsidiary's functional currency is not the parent's presentation currency, then the current rate method is applied. Under the current rate method, inventory is translated at the current exchange rate and the cost of sales expense is translated at the average exchange rate for the period. If the parent's currency is depreciating, then the translated inventory turnover ratio will have a lower change in its numerator than its denominator and this causes the translated inventory turnover to be lower. This is best seen by doing the calculations using assumed numbers.

Assume that subsidiary's ending inventory is FC4 million and its cost of sales equals FC40 million. In FC, the inventory turnover is 10.0 (40/4). Also assume that the parent's reporting currency is dollars and that the average exchange rate for the period, which is applied to cost of sales, is $1 = FC1.1 and the current exchange rate, which is applied to the inventory, is $1 = FC1.0 (note that the dollar is depreciating; it buys

less FC by the end of the year). The inventory of FC4 million is translated into $4 million (FC4 million × $1/FC1) and the cost of sales amount of FC 40 million is translated into $36.36 million (FC40 million × $1/1.1FC). In dollars, the inventory turnover is 9.1 ($36.36 million/$4 million). Thus, the inventory turnover ratio fell.

Rationale

The same.

The inventory turnover is calculated as cost of sales/average inventory, but the question states that only ending inventory is to be used in the ratio. If the subsidiary's functional currency is not the parent's presentation currency, then the current rate method is applied. Under the current rate method, inventory is translated at the current exchange rate and the cost of sales expense is translated at the average exchange rate for the period. If the parent's currency is depreciating, then the translated inventory turnover ratio will have a lower change in its numerator than its denominator and this causes the translated inventory turnover to be lower. This is best seen by doing the calculations using assumed numbers.

Assume that subsidiary's ending inventory is FC4 million and its cost of sales equals FC40 million. In FC, the inventory turnover is 10.0 (40/4). Also assume that the parent's reporting currency is dollars and that the average exchange rate for the period, which is applied to cost of sales, is $1 = FC1.1 and the current exchange rate, which is applied to the inventory, is $1 = FC1.0 (note that the dollar is depreciating; it buys less FC by the end of the year). The inventory of FC4 million is translated into $4 million (FC4 million × $1/FC1) and the cost of sales amount of FC 40 million is translated into $36.36 million (FC40 million × $1/1.1FC). In dollars, the inventory turnover is 9.1 ($36.36 million/$4 million). Thus, the inventory turnover ratio fell.

Question 24

L2FR-TBX107-1502

LOS: LOS-7110

Lesson Reference: Lesson 4: Multinational Operations and the Company's Effective Tax Rate and Foreign Currency–Related Disclosures

Difficulty: easy

Which of the following is *least likely* to lead to a lower effective tax rate for a company with multinational operations?

- (selected) Stricter laws and practices relating to transfer pricing.
- A shifting of profit mix towards countries with lower statutory tax rates.
- Lower statutory tax rates in the countries that the company does business.

Rationale

This Answer is Correct

Transfer pricing refers to the practice of related companies setting the prices of intercompany transactions such that profit is recognized in jurisdictions with the most favorable tax regimes. Should the rules and practices relating to transfer pricing be tightened and the practice restricted, this may lead to higher effective tax rates for international corporations.

Question 25
L2R20TB-ITEMSET-AC004-1512
LOS: LOS-7090
LOS: LOS-7130
LOS: LOS-7080
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium

Use the following information to answer the next three questions:

AlloCor is a large multinational holding company with foreign operations worldwide, all in stable, non-inflationary countries. Erin Arkan, CFA, is an analyst in the finance and business development department of AlloCor and is responsible for reviewing the performance of the more recently established subsidiaries. GemStone is a foreign subsidiary that AlloCor opened on December 31, 20X1.

Arkan gathers the forecasted balance sheet for GemStone's first year of operations and relevant exchange rate information in Exhibits 1 and 2. Arkan wants to analyze the effect of foreign currency translation on the consolidated financial statements of AlloCor given anticipated exchange rates. AlloCor's presentation currency is the euro.

Exhibit 1

Projected GemStone Balance Sheet as of December 31, 20X2 (in thousands; foreign currency units)

	20X2	20X1
Assets		
Cash	360.0	500.0
Accounts receivable	300.0	
Inventory	250.0	
Total current assets	910.0	500.0
Plant, property, and equipment	500.0	500.0
Less: Accumulated depreciation	(50.0)	
Total assets	1,360.0	1,000.0
Liabilities		
Accounts payable	200.0	
Total current liabilities	200.0	
Notes payable	500.0	500.0
Total liabilities	700.0	500.0
Common stock	500.0	500.0
Retained earnings	160.0	
Total liabilities & equity	1,360.0	1,000.0

Exhibit 2

Exchange Rate Information for GemStone (actual and forecast) Euros per foreign currency unit	
December 31, 20X1 (actual)	€9.0 per 1 FC
Average, 20X2 (forecast)	€9.5 per 1FC
Weighted-average rate forecasted for when inventory is acquired	€9.2 per 1 FC
December 31, 20X2 (forecast)	€10.0 per 1 FC

Use the data in Exhibits 1 and 2 to answer the following three questions:

i.

If Arkan's analysis considers the foreign currency to be GemStone's functional currency, the translated financial statements as compared to the local currency financial statements will show a receivables turnover ratio that is:

- (selected) lower.
- higher.
- the same.

Rationale

This Answer is Correct

If Arkan considers the foreign currency to be GemStone's functional currency, the current rate method is applied. Under the current rate method, revenue is translated at the average rate for the year and accounts receivable is translated at the current rate as of the year end. As Exhibit 2 shows, the foreign currency is appreciating. The ratio's numerator, which is sales, will be translated into euros at the 9.5 euros per FC unit rate, while the ratio's denominator, accounts receivable, will be translated into euros at the 10.0 euros per FC unit rate. The result is that the receivables turnover ratio will be lower after translation than it is in local currency.

Rationale

This Answer is Correct

If Arkan considers the foreign currency to be GemStone's functional currency, the current rate method is applied. Under the current rate method, revenue is translated at the average rate for the year and accounts receivable is translated at the current rate as of the year end. As Exhibit 2 shows, the foreign currency is appreciating. The ratio's numerator, which is sales, will be translated into euros at the 9.5 euros per FC unit rate, while the ratio's denominator, accounts receivable, will be translated into euros at the 10.0 euros per FC unit rate. The result is that the receivables turnover ratio will be lower after translation than it is in local currency.

Rationale

This Answer is Correct

If Arkan considers the foreign currency to be GemStone's functional currency, the current rate method is applied. Under the current rate method, revenue is translated at the average rate for the year and accounts receivable is translated at the current rate as of the year end. As Exhibit 2 shows, the foreign currency is appreciating. The ratio's numerator, which is sales, will be translated into euros at the 9.5 euros per FC unit rate, while the ratio's denominator, accounts receivable, will be translated into euros at the 10.0 euros per FC unit rate. The result is that the receivables turnover ratio will be lower after translation than it is in local currency.

ii.

If Arkan's analysis assumes foreign currency translation gains and losses will be recorded in the income statement, given the direction she anticipates exchanges rate to move, the translated financial statements are *likely* to show:

- higher revenue and higher net income than they would if exchange rates were expected to be unchanged.
- (selected) higher revenue and lower net income than they would if exchange rates were expected to be unchanged.
- lower revenue and higher net income than they would if exchange rates were expected to be unchanged.

Rationale

This Answer is Incorrect

If Arkan's analysis assumes translation gains and losses are reported on the income statement, the temporal method is applied. Exhibit 2 indicates the foreign currency is appreciating. The temporal method translates revenue at the average exchange rate resulting in higher revenue if the foreign currency is appreciating. Under the temporal method, GemStone would have a net monetary liability exposure (the 700 in liabilities exposed to current exchange rates are greater than the 660 of exposed assets). A net monetary liability position combined with an appreciating foreign currency will result in a translation loss, which causes net income to be lower.

Rationale

This Answer is Incorrect

If Arkan's analysis assumes translation gains and losses are reported on the income statement, the temporal method is applied. Exhibit 2 indicates the foreign currency is appreciating. The temporal method translates revenue at the average exchange rate resulting in higher revenue if the foreign currency is appreciating. Under the temporal method, GemStone would have a net monetary liability exposure (the 700 in liabilities exposed to current exchange rates are greater than the 660 of exposed assets). A net monetary liability position combined with an appreciating foreign currency will result in a translation loss, which causes net income to be lower.

Rationale

This Answer is Incorrect

If Arkan's analysis assumes translation gains and losses are reported on the income statement, the temporal method is applied. Exhibit 2 indicates the foreign currency is appreciating. The temporal method translates revenue at the average exchange rate resulting in higher revenue if the foreign currency is appreciating. Under the temporal method, GemStone would have a net monetary liability exposure (the 700 in liabilities exposed to current exchange rates are greater than the 660 of exposed assets). A net monetary liability position combined with an appreciating foreign currency will result in a translation loss, which causes net income to be lower.

iii.

Arkan's analysis includes translating the financial statements under both the current rate and temporal methods. The translated value of 20X2 retained earnings when the functional currency is the euro is *closest to* (in thousands of foreign currency units):

- 1,450
- 1,525
- 1,650

Rationale

This Answer is Incorrect

If the functional currency is the euro (the parent company's presentation currency), the temporal method is used. Under the temporal method, the retained earnings is essentially a “plug” amount that will bring the balance sheet into balance. All assets, liabilities, and equity accounts other than retained earnings are translated at the required exchange rates into the reporting currency and then the retained earnings in reporting currency units are found as the amount needed to balance the balance sheet.

The following translation worksheet calculates retained earnings under the temporal method.

Translation Worksheet

Balance Sheet, December 31, 20X0

Assets	Foreign Currency units (000s)		Euros (000s)
Cash	360.0	10.0 C	3,600.0
Accounts receivable	300.0	10.0 C	3,000.0
Inventory	250.0	9.2 H	2,300.0
Total current assets	910.0		8,900.0
PP&E	500.0	9.0 H	4,500.0
Less: Accum. deprec.	(50)	9.0 H	(450)
Total assets	1,360.0		12,950.0
Liabilities			
Accounts payable	200.0	10.0 C	2,000.0
Total current liabilities	200.0		2,000.0
Notes payable	500.0	10.0 C	5,000.0
Total liabilities	700.0		7,000.0
Common stock	500.0	9.0 H	4,500.0
Retained earnings	160.0	*	1,450.0
Total liabilities & equity	1,360.0		12,950.0

* The retained earnings balance is the amount needed to balance the balance sheet.

Rationale

This Answer is Incorrect

If the functional currency is the euro (the parent company's presentation currency), the temporal method is used. Under the temporal method, the retained earnings is essentially a “plug” amount that will bring the balance sheet into balance. All assets, liabilities, and equity accounts other than retained earnings are translated at the required exchange rates into the reporting currency and then the retained earnings in reporting currency units are found as the amount needed to balance the balance sheet.

The following translation worksheet calculates retained earnings under the temporal method.

Translation Worksheet

Balance Sheet, December 31, 20X0

Assets	Foreign Currency units (000s)		Euros (000s)
Cash	360.0	10.0 C	3,600.0
Accounts receivable	300.0	10.0 C	3,000.0
Inventory	250.0	9.2 H	2,300.0
Total current assets	910.0		8,900.0
PP&E	500.0	9.0 H	4,500.0

Translation Worksheet

Balance Sheet, December 31, 20X0

Less: Accum. deprec.	(50)	9.0 H	(450)
Total assets	1,360.0		12,950.0
Liabilities			
Accounts payable	200.0	10.0 C	2,000.0
Total current liabilities	200.0		2,000.0
Notes payable	500.0	10.0 C	5,000.0
Total liabilities	700.0		7,000.0
Common stock	500.0	9.0 H	4,500.0
Retained earnings	160.0	*	1,450.0
Total liabilities & equity	1,360.0		12,950.0

* The retained earnings balance is the amount needed to balance the balance sheet.

Rationale

This Answer is Incorrect

If the functional currency is the euro (the parent company's presentation currency), the temporal method is used. Under the temporal method, the retained earnings is essentially a “plug” amount that will bring the balance sheet into balance. All assets, liabilities, and equity accounts other than retained earnings are translated at the required exchange rates into the reporting currency and then the retained earnings in reporting currency units are found as the amount needed to balance the balance sheet.

The following translation worksheet calculates retained earnings under the temporal method.

Translation Worksheet

Balance Sheet, December 31, 0X0

Assets	Foreign Currency units (000s)		Euros (000s)
Cash	360.0	10.0 C	3,600.0
Accounts receivable	300.0	10.0 C	3,000.0
Inventory	250.0	9.2 H	2,300.0
Total current assets	910.0		8,900.0
PP&E	500.0	9.0 H	4,500.0
Less: Accum. deprec.	(50)	9.0 H	(450)
Total assets	1,360.0		12,950.0
Liabilities			
Accounts payable	200.0	10.0 C	2,000.0
Total current liabilities	200.0		2,000.0
Notes payable	500.0	10.0 C	5,000.0
Total liabilities	700.0		7,000.0
Common stock	500.0	9.0 H	4,500.0

Translation Worksheet

Balance Sheet, December 31, 0X0

Retained earnings	160.0	*	1,450.0
Total liabilities & equity	1,360.0		12,950.0

* The retained earnings balance is the amount needed to balance the balance sheet.

Question 26
L2R20TB-AC038-1512
LOS: LOS-7130
Lesson Reference: Lesson 4: Multinational Operations and the Company's Effective Tax Rate and Foreign Currency–Related Disclosures
Difficulty: medium
An analyst reviews the projected financial statements of SubCo, a foreign subsidiary, of a U.S. parent. SubCo's current assets include only cash and account receivables in the amount of 100 units of local currency and it has net fixed assets in the amount of 70 units of local currency. SubCo's only liabilities are trade payables in the amount of 110 units of local currency. Net income will *most likely* reflect a translation gain if the foreign currency is:

- ○ Weakening and the foreign currency is the functional currency.
- ○ Strengthening and the U.S. dollar is the functional currency.
- ◉ Weakening and the U.S. dollar is the functional currency.

Rationale
✖ Weakening and the foreign currency is the functional currency.
Under the temporal method, SubCo has a net monetary liability exposure. The assets exposed to the current exchange rate (100 local currency units) are less than the exposed liabilities (110 local currency units). When the foreign currency is weakening and there is a net monetary liability exposure, there is a translation gain which increases net income. If the foreign currency is the functional currency, the current rate method is used and the translation gain or loss is a component of equity and not reflected in net income.

Rationale
✖ Strengthening and the U.S. dollar is the functional currency.
Under the temporal method, SubCo has a net monetary liability exposure. The assets exposed to the current exchange rate (100 local currency units) are less than the exposed liabilities (110 local currency units). When the foreign currency is weakening and there is a net monetary liability exposure, there is a translation gain which increases net income. If the foreign currency is the functional currency, the current rate method is used and the translation gain or loss is a component of equity and not reflected in net income.

Rationale
✔ Weakening and the U.S. dollar is the functional currency.
Under the temporal method, SubCo has a net monetary liability exposure. The assets exposed to the current exchange rate (100 local currency units) are less than the exposed liabilities (110 local currency units). When the foreign currency is weakening and there is a net monetary liability exposure, there is a translation gain which increases net income. If the foreign currency is the functional currency, the current rate method is used and the translation gain or loss is a component of equity and not reflected in net income.

Question 27
L2FR-PQ1927-1410
LOS: LOS-7070
LOS: LOS-7080
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
If the parent's presentation currency is expected to decline over the year, and if the subsidiary's local currency is used as the functional currency, the parent will *most likely* report:

- (selected) An addition to the cumulative translation adjustment for the year.
- A deduction from the cumulative translation adjustment for the year.
- A translation gain on the income statement.

Rationale

This Answer is Correct

If the local currency is used as the functional currency, the current rate method is applied, where balance sheet exposure of the parent equals the net asset position of the foreign subsidiary. Given that net assets of the subsidiary are typically positive, an appreciation of the foreign currency will lead to a positive translation adjustment in shareholders' equity.

Question 28
L200-PQ0012-1412
LOS: LOS-7110
Lesson Reference: Lesson 4: Multinational Operations and the Company’s Effective Tax Rate and Foreign Currency–Related Disclosures
Difficulty: medium
If a company does business in many countries, each with its own effective tax rate, how would capital projects and their associated profits be allocated among the countries?

- ○ The projects with the highest IRRs go to the countries with the highest tax rate.
- ○ The projects with the lowest IRRs go to the countries with the lowest tax rate.
- ◉ The projects with the highest IRRs go to the countries with the lowest tax rate.

Rationale

This Answer is Correct

The projects with the highest expected levels of profit go to the countries with the lowest tax rate so that a higher portion of profits is allocated to lower-tax-rate jurisdictions.

Question 29
L200-PQ0010-1412
LOS: LOS-7040
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium
With respect to multinational operations, the currency of the primary business environment in which an entity operates is:

- Presentation currency (PC)
- Functional currency (FC)
- The weighted average value of currencies

Rationale

This Answer is Correct

The functional currency (FC) is the currency of the primary business environment in which an entity operates.

Question 30
L2R20TB-ITEMSET-AC033-1512
LOS: LOS-7100
Lesson Reference: Lesson 3: Translation of Foreign Currency Financial Statements: Hyperinflationary Economies
Difficulty: medium
Use the following information to answer the next two questions:
i.
SubCo is a foreign subsidiary operating in a highly inflationary economy. The parent company complies with IFRS. An analyst reviewing the translated balance sheet is *most likely* to assume that:

- There is no restatement for inflation.
- All balance sheet accounts are restated for inflation.
- Only non-monetary assets and liabilities and stockholder equity accounts are restated for inflation.

Rationale
This Answer is Correct
SubCo operates in a highly inflationary economy and SubCo's parent complies with IFRS; therefore, the accounting treatment is to restate the financial statements for inflation and translate at the current rate. The specific procedures state that only non-monetary assets and liabilities and stockholder equity accounts are restated. Monetary assets and liabilities are not restated for inflation. U.S. GAAP does not allow for restatement of inflation and requires the use of the temporal method in a highly inflationary economy.

Rationale
This Answer is Correct
SubCo operates in a highly inflationary economy and SubCo's parent complies with IFRS; therefore, the accounting treatment is to restate the financial statements for inflation and translate at the current rate. The specific procedures state that only non-monetary assets and liabilities and stockholder equity accounts are restated. Monetary assets and liabilities are not restated for inflation. U.S. GAAP does not allow for restatement of inflation and requires the use of the temporal method in a highly inflationary economy.

Rationale
This Answer is Incorrect
SubCo operates in a highly inflationary economy and SubCo's parent complies with IFRS; therefore, the accounting treatment is to restate the financial statements for inflation and translate at the current rate. The specific procedures state that only non-monetary assets and liabilities and stockholder equity accounts are restated. Monetary assets and liabilities are not restated for inflation. U.S. GAAP does not allow for restatement of inflation and requires the use of the temporal method in a highly inflationary economy.

ii.

SubCo is a foreign subsidiary operating in a highly inflationary economy. Its parent complies with U.S. GAAP. SubCo's balance sheet at year end is as follows:

Foreign Currency Units, Year End, 20X2

Cash	3,500	Notes payable	2,000
Fixed assets	3,000	Total equity	4,500
Total assets	6,500	Total liabilities and equity	6,500

In the translated financial statements, the analyst is *most likely* to find a purchasing power:

- Loss reported in net income.
- Gain reported in net income.
- Loss reported as a component of stockholders' equity.

Rationale

This Answer is Incorrect

SubCo operates in a highly inflationary economy and its parent complies with U.S. GAAP, so it will translate the foreign currency financial statements using the temporal method. This method results in a net monetary asset exposure (exposed monetary assets of 3,500 are greater than exposed monetary liabilities of 2,000). A net purchasing power loss will result when there is net monetary asset exposure. The temporal method reports purchasing power gains and losses on the income statement.

Rationale

This Answer is Incorrect

SubCo operates in a highly inflationary economy and its parent complies with U.S. GAAP, so it will translate the foreign currency financial statements using the temporal method. This method results in a net monetary asset exposure (exposed monetary assets of 3,500 are greater than exposed monetary liabilities of 2,000). A net purchasing power loss will result when there is net monetary asset exposure. The temporal method reports purchasing power gains and losses on the income statement.

Rationale

This Answer is Incorrect

SubCo operates in a highly inflationary economy and its parent complies with U.S. GAAP, so it will translate the foreign currency financial statements using the temporal method. This method results in a net monetary asset exposure (exposed monetary assets of 3,500 are greater than exposed monetary liabilities of 2,000). A net purchasing power loss will result when there is net monetary asset exposure. The temporal method reports purchasing power gains and losses on the income statement.

Question 31
L2R20TB-ITEMSET-AC031-1512
LOS: LOS-7070
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium

Use the following information to answer the next two questions:

Harkin Products (HP) is a Japan-based multinational with production centers worldwide. Markus Knight is an analyst in HP's accounting and finance department. Knight worked on the team responsible for launching LymCo, HP's U.S. manufacturing subsidiary. On January 1, 20X0, HP invested $2 million in equity and secured a U.S. dollar-denominated note payable of $2 million to purchase fixed assets of $3 million and have $1 million in cash on hand to launch LymCo.

Markus Knight is tasked with reporting on LymCo's first year of operations. Knight starts by reviewing LymCo's financial statements and related disclosures. Next, he compiles financial statement data and exchange rate information in Exhibit 1 and notes that LymCo acquired and sold inventory evenly throughout the year.

EXHIBIT 1: Selected Financial and Exchange Rate Information

Balance Sheet December 31, 20X0 ($000)

Assets		**Liabilities**	
Cash	$600.0	Accounts payable	$1,000.0
Accounts receivable	1,000.0	Total current liabilities	1,000.0
Inventory	1,000.0	Notes payable	2,000.0
Total current assets	$2,600.0	Total liabilities	$3,000.0
Equipment	3,000.0	Common stock	2,000.0
Less: Accum. Dep.	(300)	Retained earnings	300
Total assets	$5,300.0	Total liabilities & equity	$5,300.0

Income Statement and Statement of Retained Earnings, 20X0 ($000)		Exchange Rate Information (Japanese yen per U.S.$)	
Sales	$8,000.0	January 1, 20X0	110.0
Cost of goods sold	(6,000.0)	Average, 20X0	100.0
Selling expenses	(800.0)	Weighted-average rate, inventory	99.0
Depreciation expense	(300.0)	December 1, 20X0, dividends declared	96.0
Interest expense	(200.0)	December 31, 20X0	90.0
Income tax	(300.0)		
Net income	$ **400.0**		
Less: Dividends	(100.0)		
Retained earnings	$ **300.0**		

Use Exhibit 1 and the information provided to answer the following two questions.

i.
LymCo is autonomous in the majority of its operating and financing decisions. Assuming this autonomy is the basis for determining LymCo's functional currency, Knight determines that HP reports LymCo's translation gains and losses as:

- part of net income and LymCo has a net liability balance sheet exposure.

- a component of stockholder's equity and LymCo has a net asset balance sheet exposure.
- a component of stockholder's equity and LymCo has a net liability balance sheet exposure.

Rationale

This Answer is Correct

LymCo’s autonomy within the US suggests USD as is its functional currency, so HP should translate LymCo’s balances into JPY using the current exchange rate for USD to JPY. The result of translation under the current method appears as a Cumulative Translation Adjustment (CTA) in Equity. Total assets are greater than total liabilities, indicating a net asset exposure for translating the balance sheet.

Rationale

This Answer is Correct

LymCo’s autonomy within the US suggests USD as is its functional currency, so HP should translate LymCo’s balances into JPY using the current exchange rate for USD to JPY. The result of translation under the current method appears as a Cumulative Translation Adjustment (CTA) in Equity. Total assets are greater than total liabilities, indicating a net asset exposure for translating the balance sheet.

Rationale

This Answer is Incorrect

LymCo’s autonomy within the US suggests USD as is its functional currency, so HP should translate LymCo’s balances into JPY using the current exchange rate for USD to JPY. The result of translation under the current method appears as a Cumulative Translation Adjustment (CTA) in Equity. Total assets are greater than total liabilities, indicating a net asset exposure for translating the balance sheet.

ii.

Knight is interested in the effect that translation methods have on net income and retained earnings. Under the temporal method, Knight would calculate the translated value of LymCo's 20X0 retained earnings as being *closest to*:

- ¥30.4 million and net income will be lower than it would be under the current rate method.
- ¥50 million and net income will be higher than it would be under the current rate method.
- ¥50 million and net income will be lower than it would be under the current rate method.

Rationale

This Answer is Incorrect

All assets are purchased at the beginning of the period so that depreciation is translated at historical cost. Inventory was acquired evenly through the first year, so will appear at historical costs if market value is lower and at current rate if cost was lower. The assumption of lower cost and thus the use of average inventory cost through the first year makes retained earnings close to $50 million. Use of historical cost results in a higher depreciation expense, lower net income, and a translation loss. Therefore, net income is lower for the temporal method than under the current rate method.

Rationale

This Answer is Incorrect

All assets are purchased at the beginning of the period so that depreciation is translated at historical cost. Inventory was acquired evenly through the first year, so will appear at historical costs if market value is lower and at current rate if cost was lower. The assumption of lower cost and thus the use of average inventory cost through the first year makes retained earnings close to $50 million. Use of historical cost results in a higher depreciation expense, lower net income, and a translation loss. Therefore, net income is lower for the temporal method than under the current rate method.

Rationale

This Answer is Incorrect

All assets are purchased at the beginning of the period so that depreciation is translated at historical cost. Inventory was acquired evenly through the first year, so will appear at historical costs if market value is lower and at current rate if cost was lower. The assumption of lower cost and thus the use of average inventory cost through the first year makes retained earnings close to $50 million. Use of historical cost results in a higher depreciation expense, lower net income, and a translation loss. Therefore, net income is lower for the temporal method than under the current rate method.

Question 32
L2R20TB-ITEMSET-AC001-1512
LOS: LOS-7090
LOS: LOS-7080
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium

Use the following information to answer the next three questions:

A Japanese company, JayCo, established a wholly owned European subsidiary, EuroStar, on January 1, 20X2. In addition to its initial equity investment of €1.2 million, on January 1, 20X2 JayCo purchased equipment valued at €2 million, financed by a euro-denominated note payable to a European bank. Eurostar's local currency is the euro.

Reilly Jones, CFA, reviews Eurostar's first year of operations and presents the financial statements and relevant exchange rate information in Exhibit 1.

Exhibit 1: Select Financial and Exchange Rate Information for EuroStar, 20X2

Eurostar Balance Sheet as of December 31, 20X2 (€000)			
Assets		Liabilities	
Cash	490.0	Accounts payable	300.0
Accounts receivable	1,000.0	**Total current liabilities**	**300.0**
Inventory	1,000.0	Notes payable	2,000.0
Total current assets	**2,490.0**	**Total liabilities**	**2,300.0**
Plant, property, and equipment	2,000.0	Common stock	1,200.0
Less: Accumulated depreciation	(200.0)	Retained earnings	790.0
Total assets	**4,290.0**	**Total liabilities & equity**	**4,290.0**
Eurostar Income Statement and Statement of Retained Earnings, 20X2 (€000)		Spot exchange rates for Japanese yen per euro	
Sales	10,000.0		
Cost of goods sold	(7,000.0)	January 1, 20X2	100.0
Selling expenses	(800.0)	Weighted-average rate when inventory was acquired	105.0
Depreciation expenses	(200.0)		
Interest expense	(160.0)	Average exchange rate, 20X2	107.0
Income tax	(600.0)	December 15, 20X2 when dividends were declared	110.0
Net income	**1,240.0**		
Less: Dividends	(450.0)	December 31, 20X2	114.0
Retained earnings	**790.0**		

Jones is interested in the implications of foreign currency exchange rate fluctuations and the use of translation methods on consolidated financial statements. He also wants to explore the impact of a change in capital structure. As part of his analysis he runs the following scenario: Scenario: Assume JayCo finances Eurostar on January 1, 20X2 with €3.2 million in equity and no long-term debt, and these balances remain at December 31, 20X2; all else remains the same.

Use the data in Exhibit 1 to answer the following three questions:

i.

If Jones assumes EuroStar's functional currency is the euro, for the year ended December 31, 20X2, JayCo's translated financial statements will *most likely* include a foreign currency translation:

- gain included in JayCo's consolidated income statement.
- gain as a separate component of stockholders' equity.
- loss as a separate component of stockholders' equity.

Rationale

This Answer is Correct

If EuroStar's functional currency is the foreign currency (euro), the current rate method is applied, which reports translation gains or losses as a separate component of stockholders' equity. A gain or loss can be reasoned by looking at the direction of the exchange rates and the balance sheet exposure. Under the current method, there is always a net asset exposure unless there is negative stockholders' equity. All the assets are exposed to changes in the current exchange rate (€4.29 million), which is greater than the exposed liabilities (€2.3 million). The foreign currency is appreciating, which leads us to assume a foreign currency translation gain.

Rationale

This Answer is Correct

If EuroStar's functional currency is the foreign currency (euro), the current rate method is applied, which reports translation gains or losses as a separate component of stockholders' equity. A gain or loss can be reasoned by looking at the direction of the exchange rates and the balance sheet exposure. Under the current method, there is always a net asset exposure unless there is negative stockholders' equity. All the assets are exposed to changes in the current exchange rate (€4.29 million), which is greater than the exposed liabilities (€2.3 million). The foreign currency is appreciating, which leads us to assume a foreign currency translation gain.

Rationale

This Answer is Correct

If EuroStar's functional currency is the foreign currency (euro), the current rate method is applied, which reports translation gains or losses as a separate component of stockholders' equity. A gain or loss can be reasoned by looking at the direction of the exchange rates and the balance sheet exposure. Under the current method, there is always a net asset exposure unless there is negative stockholders' equity. All the assets are exposed to changes in the current exchange rate (€4.29 million), which is greater than the exposed liabilities (€2.3 million). The foreign currency is appreciating, which leads us to assume a foreign currency translation gain.

ii.

If Jones assumes EuroStar's functional currency is the parent's presentation currency, he will calculate that Eurostar's translated total assets are *closest to*:

- ¥434.0 million.
- ¥454.9 million.
- ¥489.1 million.

Rationale

This Answer is Incorrect

If EuroStar's functional currency is the parent's presentation currency (yen), the temporal method is applied. The following translation worksheet compares the current and the temporal method in calculating EuroStar's total assets. Note the key differences in the rates used for the non-monetary assets under the temporal method: the weighted-average rate is used as the historic rate for inventory and the January 1, 20X2 exchange rate (the rate at the time the fixed assets were purchased) is used for PPE and accumulated depreciation. Note as well that the current rate is applied to monetary assets, not a historical rate.

EuroStar December 31, 20X2 (000)		**Current Rate**		**Temporal**	
Cash	€490	114	¥55,860	114	¥55,860
Accounts receivable	1,000	114	114,000	114	114,000
Inventory	1,000	114	114,000	105	105,000
Total current assets	€2,490		¥283,860		¥274,860
Property, plant, and equipment	2,000	114	228,000	100	200,000
Less: Accumulated depreciation	(200)	114	(22,800)	100	(20,000)
Total assets	€4,290		¥489,060		¥454,860

Rationale

This Answer is Incorrect

If EuroStar's functional currency is the parent's presentation currency (yen), the temporal method is applied. The following translation worksheet compares the current and the temporal method in calculating EuroStar's total assets. Note the key differences in the rates used for the non-monetary assets under the temporal method: the weighted-average rate is used as the historic rate for inventory and the January 1, 20X2 exchange rate (the rate at the time the fixed assets were purchased) is used for PPE and accumulated depreciation. Note as well that the current rate is applied to monetary assets, not a historical rate.

EuroStar December 31, 20X2 (000)		**Current Rate**		**Temporal**	
Cash	€490	114	¥55,860	114	¥55,860
Accounts receivable	1,000	114	114,000	114	114,000
Inventory	1,000	114	114,000	105	105,000
Total current assets	€2,490		¥283,860		¥274,860
Property, plant, and equipment	2,000	114	228,000	100	200,000
Less: Accumulated depreciation	(200)	114	(22,800)	100	(20,000)
Total assets	€4,290		¥489,060		¥454,860

Rationale

This Answer is Incorrect

If EuroStar's functional currency is the parent's presentation currency (yen), the temporal method is applied. The following translation worksheet compares the current and the temporal method in calculating EuroStar's total assets. Note the key differences in the rates used for the non-monetary assets under the temporal method: the weighted-average rate is used as the historic rate for inventory and the January 1, 20X2 exchange rate (the rate at the time the fixed assets were purchased) is used for PPE and accumulated depreciation. Note as well that the current rate is applied to monetary assets, not a historical rate.

EuroStar December 31, 20X2 (000)		**Current Rate**		**Temporal**	
Cash	€490	114	¥55,860	114	¥55,860
Accounts receivable	1,000	114	114,000	114	114,000
Inventory	1,000	114	114,000	105	105,000

EuroStar December 31, 20X2 (000)		Current Rate	Temporal
Total current assets	€2,490	¥283,860	¥274,860
Property, plant, and equipment	2,000	114 228,000	100 200,000
Less: Accumulated depreciation	(200)	114 (22,800)	100 (20,000)
Total assets	€4,290	¥489,060	¥454,860

iii.

When Jones runs the change in capital structure scenario, as compared to the original capital structure, the translated financial statements under the temporal method for this scenario *most likely* result in a net:

- ○ liability exposure and higher retained earnings.
- ● asset exposure and higher retained earnings.
- ○ asset exposure and lower retained earnings.

Rationale

This Answer is Incorrect

If JayCo uses all equity to establish Eurostar and no debt, under the temporal method, the balance sheet exposure of EuroStar changes from a net liability exposure of €0.81 mil (€1.49 – 2.30) to a net asset exposure of €1.19 mil (€1.49 – 0.3). The foreign currency is appreciating throughout 20X2, therefore the notes payable would have been translated at the higher current rate than the common stock which is translated at the historical rate. The retained earnings necessary to keep the balance sheet in balance must be higher when the notes payables are no longer present and the local currency common stock balance is €3.2 million.

Another way to look at this is that the notes payable would have been exposed to the change in exchange rates (foreign exchange risk) in the amount of ¥28 million [(¥114/€ – ¥100/€) × €2 million]. This liability exposure would have been a loss, a decrease to net income and thus a reduction to retained earnings. Since using all equity financing will eliminate this loss, the retained earnings increases above its level in the original capital structure.

Rationale

This Answer is Incorrect

If JayCo uses all equity to establish Eurostar and no debt, under the temporal method, the balance sheet exposure of EuroStar changes from a net liability exposure of €0.81 mil (€1.49 – 2.30) to a net asset exposure of €1.19 mil (€1.49 – 0.3). The foreign currency is appreciating throughout 20X2, therefore the notes payable would have been translated at the higher current rate than the common stock which is translated at the historical rate. The retained earnings necessary to keep the balance sheet in balance must be higher when the notes payables are no longer present and the local currency common stock balance is €3.2 million.

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Rationale

This Answer is Incorrect

If JayCo uses all equity to establish Eurostar and no debt, under the temporal method, the balance sheet exposure of EuroStar changes from a net liability exposure of €0.81 mil (€1.49 – 2.30) to a net asset exposure of €1.19 mil (€1.49 – 0.3). The foreign currency is appreciating throughout 20X2, therefore the notes payable would have been translated at the higher current rate than the common stock which is translated at the historical rate. The retained earnings necessary to keep the balance sheet in balance must be higher when the notes payables are no longer present and the local currency common stock balance is €3.2 million.

Another way to look at this is that the notes payable would have been exposed to the change in exchange rates (foreign exchange risk) in the amount of ¥28 million [(¥114/€ – ¥100/€) × €2 million]. This liability exposure would have been a loss, a decrease to net income and thus a reduction to retained earnings. Since using all equity financing will eliminate this loss, the retained earnings increases above its level in the original capital structure.

Question 33
L2FR-TBX108-1502
LOS: LOS-7120
Lesson Reference: Lesson 4: Multinational Operations and the Company's Effective Tax Rate and Foreign Currency–Related Disclosures
Difficulty: easy

An analyst collects the following information from the MD&A of two international companies regarding the sources of their sales growth:

	Volume growth	Price	Foreign exchange	Net sales growth
Company A	6%	1%	0%	7%
Company B	4%	1%	2%	7%

Which of the following statements is *most likely* to be accurate regarding earnings sustainability?

- (selected) Company A is most likely to have higher earnings sustainability.
- Company B is most likely to have higher earnings sustainability.
- The companies are likely to have equal earnings sustainability.

Rationale

This Answer is Correct

Sales growth derived from foreign exchange movements is likely to be less sustainable than that derived from volume growth or price changes.

Question 34
L2R20TB-AC007-1512
LOS: LOS-7040
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium

An analyst reads the following disclosure from the financial statements of a large multinational education company: “The financial position and results of operations of our foreign subsidiaries in XX countries … are measured using the U.S. dollar as the functional currency. As such, there is no translation gain or loss associated with these operations on the income statement.”

The *least likely* conclusion the analyst can draw is that the foreign subsidiaries':

- (selected) local currency is not the same as the functional currency.
- functional currency is the same as their presentation currency.
- presentation currency is the same as the parent's presentation currency.

Rationale

✓ **local currency is not the same as the functional currency.**

The disclosure states there is no translation gain or loss associated with its foreign operations because the functional currency is the U.S. dollar. If there is no translation adjustment, the foreign operations must use the parent's presentation currency as their presentation currency. Hence, there is no translation required and no translation would imply that the parent's presentation currency is the U.S. dollar. So the analyst can conclude that the functional currency is the same as the subsidiary's presentation currency and its presentation currency is the same as the parent's presentation currency. But, the analyst cannot conclude that the local currency is not the same as the functional currency. It is possible that the foreign operations also have the functional currency (which is the presentation currency for both the parent and the subsidiaries) as their local currency because often the local and presentation currencies are the same.

Rationale

✗ **functional currency is the same as their presentation currency.**

The disclosure states there is no translation gain or loss associated with its foreign operations because the functional currency is the U.S. dollar. If there is no translation adjustment, the foreign operations must use the parent's presentation currency as their presentation currency. Hence, there is no translation required and no translation would imply that the parent's presentation currency is the U.S. dollar. So the analyst can conclude that the functional currency is the same as the subsidiary's presentation currency and its presentation currency is the same as the parent's presentation currency. But, the analyst cannot conclude that the local currency is not the same as the functional currency. It is possible that the foreign operations also have the functional currency (which is the presentation currency for both the parent and the subsidiaries) as their local currency because often the local and presentation currencies are the same.

Rationale

✗ **presentation currency is the same as the parent's presentation currency.**

The disclosure states there is no translation gain or loss associated with its foreign operations because the functional currency is the U.S. dollar. If there is no translation adjustment, the foreign operations must use the parent's presentation currency as their presentation currency. Hence, there is no translation required and no translation would imply that the parent's presentation currency is the U.S. dollar. So the analyst can

conclude that the functional currency is the same as the subsidiary's presentation currency and its presentation currency is the same as the parent's presentation currency. But, the analyst cannot conclude that the local currency is not the same as the functional currency. It is possible that the foreign operations also have the functional currency (which is the presentation currency for both the parent and the subsidiaries) as their local currency because often the local and presentation currencies are the same.

Question 35
L2FR-TB0023-1412
LOS: LOS-7070
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
According to IFRS, a fully autonomous subsidiary that is making its own operational decisions should *most likely* use the:

- (selected) Current method.
- Temporal method.
- Parent's currency as its presentation currency.

Rationale

This Answer is Correct
If the subsidiary is fully autonomous then it should most likely take the local currency as the functional currency and hence the current method will be used to translate accounts.

Question 36
L2FR-PQ1925-1410
LOS: LOS-7070
LOS: LOS-7080
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium

An analyst gathered the following information regarding Lint Corporation:

Retained earnings on January 1, 2011 = $1.3 million

Cumulative translation adjustment (CTA) on January 1, 2011 = $0.26 million

Net income for 2011 = $3.8 million

Dividends declared on December 31, 2011 = $2.3 million

Total assets on December 31, 2011 = $22.5 million

Total liabilities on December 31, 2011 = $12.5 million

Common stock = $7 million

For the year 2011, Lint Corporation will *most likely* recognize a:

- ○ Translation gain of $200,000.
- ○ Translation gain of $60,000.
- ◉ Translation loss of $60,000.

Rationale

This Answer is Correct

Ending retained earnings = Beginning retained earnings + Net income – Dividends declared= 1.3m + 3.8m – 2.3m = $2.8 million

Ending CTA = Total assets – Total liabilities – Common stock – Ending retained earnings = 22.5m – 12.5m – $7m – 2.8m = $0.2 million

Translation gain/loss for the period = $0.2 – $0.26 = –$60,000

Question 37
L200-PQ0011-1412
LOS: LOS-7050
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium
Which one of the following risks does a company bear when making a purchase in a foreign currency when payment is deferred?

- ○ The value of the foreign currency goes down.
- ◉ The value of the foreign currency goes up.
- ○ The value of the domestic currency rises.

Rationale

This Answer is Correct

When a company defers payments on an item purchased with foreign currency, it bears the risk that the price of that currency goes up in value and it has to spend more domestic currency to make the purchase.

Question 38
L2R20TB-AC012-1512
LOS: LOS-7070
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
If a multinational deems its foreign operations to be fully autonomous, the translated financial statements *most likely* will translate intangible assets using the:

- average exchange rate for the period.
- exchange rate in effect when assets were acquired.
- exchange rate in effect at the end of the reporting period.

Rationale
average exchange rate for the period.
If the foreign operations are deemed fully autonomous, their functional currency most likely will be the foreign currency and the current rate method is applied. Under the current rate method, intangible assets (all assets and liabilities) are translated at the current exchange rate.

Rationale
exchange rate in effect when assets were acquired.
If the foreign operations are deemed fully autonomous, their functional currency most likely will be the foreign currency and the current rate method is applied. Under the current rate method, intangible assets (all assets and liabilities) are translated at the current exchange rate.

Rationale
exchange rate in effect at the end of the reporting period.
If the foreign operations are deemed fully autonomous, their functional currency most likely will be the foreign currency and the current rate method is applied. Under the current rate method, intangible assets (all assets and liabilities) are translated at the current exchange rate.

Question 39
L2R20TB-AC009-1512
LOS: LOS-7050
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium
EurCo, a European exporter, recently entered into a transaction which resulted in a U.S. dollar-denominated receivable. At EurCo's fiscal year-end, the U.S. dollar has depreciated against the euro, with the euro being EurCo's functional currency. EurCo changes the way it records foreign currency transaction gains or losses and decides it will be recorded in other operating income rather than non-operating income/expenses where the company has recorded these gains and losses in the past. As a result of this change in accounting and its recent transaction, EurCo's operating profit *most likely* will be:

- lower.
- higher.
- the same.

Rationale
lower.
EurCo has asset exposure to foreign currency risk since it carries a U.S.-dollar denominated receivable. At EurCo's year-end, the foreign currency (the U.S. dollar) has depreciated, so EurCo will record a foreign currency loss. If that loss were recorded as other operating income and expenses rather than non-operating income and expense, operating profit (revenues – all operating expenses) would be lower.

Rationale
higher.
EurCo has asset exposure to foreign currency risk since it carries a U.S.-dollar denominated receivable. At EurCo's year-end, the foreign currency (the U.S. dollar) has depreciated, so EurCo will record a foreign currency loss. If that loss were recorded as other operating income and expenses rather than non-operating income and expense, operating profit (revenues – all operating expenses) would be lower.

Rationale
the same.
EurCo has asset exposure to foreign currency risk since it carries a U.S.-dollar denominated receivable. At EurCo's year-end, the foreign currency (the U.S. dollar) has depreciated, so EurCo will record a foreign currency loss. If that loss were recorded as other operating income and expenses rather than non-operating income and expense, operating profit (revenues – all operating expenses) would be lower.

Question 40
L2FR-PQ1926-1410
LOS: LOS-7100
Lesson Reference: Lesson 3: Translation of Foreign Currency Financial Statements: Hyperinflationary Economies
Difficulty: medium
An analyst believes that the foreign subsidiary's local currency will depreciate and that there will be hyperinflation in the foreign economy. Which of the following would result in the *highest value* for the parent's COGS?

- If it accounts for the subsidiary's inventory using FIFO and uses the subsidiary's currency as the functional currency.
- If it accounts for the subsidiary's inventory using weighted-average cost and uses the presentation currency as the functional currency.
- If it accounts for the subsidiary's inventory using FIFO and uses the presentation currency as the functional currency.

Rationale
This Answer is Correct

In an inflationary environment (when prices are rising), the weighted-average method results in a higher value for COGS than the FIFO method.

Further, if the foreign currency is depreciating, the temporal method would result in higher COGS as it applied the (higher) historical exchange rate to translate COGS. The temporal method uses the presentation currency as the functional currency.

Question 41
L2R20TB-AC022-1512
LOS: LOS-7100
Lesson Reference: Lesson 3: Translation of Foreign Currency Financial Statements: Hyperinflationary Economies
Difficulty: medium

BritCo operates a foreign subsidiary in a highly inflationary economy and complies with IFRS. The foreign subsidiary's balance sheet for the year ended 31 December 20X1 follows:

Foreign Currency Units, Year End, 20X1

Cash	400	Notes payable	200
Land	250	Common stock	300
Total assets	650	Retained earnings	150
		Total liabilities and equity	650

In the translated financial statements, the analyst is *most likely* to find a purchasing power:

- (selected) Loss reported in net income.
- Gain reported in net income.
- Loss reported as a component of stockholders' equity.

Rationale
✔ **Loss reported in net income.**
In this scenario, the parent complies with IFRS. IFRS, when dealing with inflationary economies, requires purchasing power gains and losses to be included in net income, similar to the temporal method. The subsidiary has net a monetary asset exposure, which during periods of inflation results in a purchasing power loss.

Rationale
✘ **Gain reported in net income.**
In this scenario, the parent complies with IFRS. IFRS, when dealing with inflationary economies, requires purchasing power gains and losses to be included in net income, similar to the temporal method. The subsidiary has net a monetary asset exposure, which during periods of inflation results in a purchasing power loss.

Rationale
✘ **Loss reported as a component of stockholders' equity.**
In this scenario, the parent complies with IFRS. IFRS, when dealing with inflationary economies, requires purchasing power gains and losses to be included in net income, similar to the temporal method. The subsidiary has net a monetary asset exposure, which during periods of inflation results in a purchasing power loss.

Question 42
L2R20TB-ITEMSET-AC027-1512
LOS: LOS-7050
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium

Use the following information to answer the next four questions:

On November 15, 20X3, Bilby Inc., an Australian company, sells goods valued at €1,000,000 to Crane Enterprises, a Netherlands-based company. The payment is to be received in euros and Bilby extends credit terms of up to three months for Crane to pay. Bilby's functional and presentation currency is the Australian dollar (AUD) and its fiscal year-end is December 31. Bilby recognizes foreign currency transaction gains and losses in non-operating income/expenses. The spot exchange rates between the euro (€) and the AUD (A$) are listed below:

November 15, 20X3	€1 = A$1.440
December 24, 20X3	€1 = A$1.534
December 31, 20X3	€1 = A$1.343
February 15, 20X4	€1 = A$1.517

i.
Assuming that Crane settles the balance it owes Bilby in full on December 24, 20X3, what is the amount of account receivable that Bilby will initially record on November 15 and, as a result of this transaction, will Bilby record a foreign currency loss or gain for its fiscal year ending December 31, 20X3?

- (selected) A$1.44 million is the initial receivable and Bilby will record a foreign currency gain in 20X3.
- A$1.44 million is the initial receivable and Bilby will record a foreign currency loss in 20X3.
- A$1.534 million is the initial receivable and Bilby will record a foreign currency loss in 20X3.

Rationale

This Answer is Correct

The receivable is recorded at the transaction date using the spot rate of €1 = A$1.440 at that time. Therefore, the initial receivable recorded is A$1.44 million (€1,000,000 × A$1.44/€1). If settled on December 24, 20X3, the foreign currency transaction gain or loss is determined based on the spot rate of €1 = A$1.534 at the time of settlement. The underlying assumption is that Bilby receives €1,000,000 and converts the euros to A$1.534 million (€1,000,000 × A$1.534/€1). Since the assumed amount received of A$1.534 million is greater than the initial receivable recorded of A$1.44 million, Bilby has a foreign currency gain of A$94,000 for 20X3. Note that since the foreign currency (euro) has appreciated, Bilby was able to exchange the payment received on its euro-denominated receivable into more (gain) of its functional currency (AUD).

Rationale

This Answer is Correct

The receivable is recorded at the transaction date using the spot rate of €1 = A$1.440 at that time. Therefore, the initial receivable recorded is A$1.44 million (€1,000,000 × A$1.44/€1). If settled on December 24, 20X3, the foreign currency transaction gain or loss is determined based on the spot rate of €1 = A$1.534 at the time of settlement. The underlying assumption is that Bilby receives €1,000,000 and converts the euros to A$1.534 million (€1,000,000 × A$1.534/€1). Since the assumed amount received of A$1.534 million is greater than the initial receivable recorded of A$1.44 million, Bilby has a foreign currency gain of A$94,000 for 20X3. Note that since the foreign currency (euro) has appreciated, Bilby was able to exchange the payment received on its euro-denominated receivable into more (gain) of its functional currency (AUD).

Rationale

This Answer is Correct

The receivable is recorded at the transaction date using the spot rate of €1 = A$1.440 at that time. Therefore, the initial receivable recorded is A$1.44 million (€1,000,000 × A$1.44/€1). If settled on December 24, 20X3, the foreign currency transaction gain or loss is determined based on the spot rate of €1 = A$1.534 at the time of settlement. The underlying assumption is that Bilby receives €1,000,000 and converts the euros to A$1.534 million (€1,000,000 × A$1.534/€1). Since the assumed amount received of A$1.534 million is greater than the initial receivable recorded of A$1.44 million, Bilby has a foreign currency gain of A$94,000 for 20X3. Note that since the foreign currency (euro) has appreciated, Bilby was able to exchange the payment received on its euro-denominated receivable into more (gain) of its functional currency (AUD).

ii.

If Crane chooses to defer payment until 20X4 and pays in full on February 15, 20X4, Bilby, with respect to this transaction, will record an:

- ○ unrealized foreign currency loss in 20X3 and a foreign currency loss in 20X4.
- ● unrealized foreign currency loss in 20X3 and a foreign currency gain in 20X4.
- ○ unrealized foreign currency gain in 20X3 and a foreign currency gain in 20X4.

Rationale

This Answer is Correct

Between the November 15 transaction date and the December 31 year-end, the AUD strengthened (it takes fewer AUD to buy one euro). As a result, Bilby has an unrealized loss on its December 31 financial statements due to this transaction. At year-end, the receivable is worth A$1.343 million (€1,000,000 × A$1.343/€1) and Bilby initially recorded a receivable of A$1.44 million (€1,000,000 × A$1.44/€1). The receivable initially recorded has to be written down to reflect the year-end spot exchange rate and the offset is an unrealized loss on Bilby's income statement.

When Bilby receives the €1,000,000 payment on February 15, it will have the ability to convert the euros into A$1.517 million (€1,000,000 × A$1.517/€1) at the current spot rate. The difference between the A$1.517 million and recorded year-end receivable of A$1.343 million represents a foreign currency gain.

Rationale

This Answer is Incorrect

Between the November 15 transaction date and the December 31 year-end, the AUD strengthened (it takes fewer AUD to buy one euro). As a result, Bilby has an unrealized loss on its December 31 financial statements due to this transaction. At year-end, the receivable is worth A$1.343 million (€1,000,000 × A$1.343/€1) and Bilby initially recorded a receivable of A$1.44 million (€1,000,000 × A$1.44/€1). The receivable initially recorded has to be written down to reflect the year-end spot exchange rate and the offset is an unrealized loss on Bilby's income statement.

When Bilby receives the €1,000,000 payment on February 15, it will have the ability to convert the euros into A$1.517 million (€1,000,000 × A$1.517/€1) at the current spot rate. The difference between the A$1.517 million and recorded year-end receivable of A$1.343 million represents a foreign currency gain.

Rationale

This Answer is Incorrect

Between the November 15 transaction date and the December 31 year-end, the AUD strengthened (it takes fewer AUD to buy one euro). As a result, Bilby has an unrealized loss on its December 31 financial statements due to this transaction. At year-end, the receivable is worth A$1.343 million (€1,000,000 × A$1.343/€1) and Bilby initially recorded a receivable of A$1.44 million (€1,000,000 × A$1.44/€1). The receivable initially recorded has to be written down to reflect the year-end spot exchange rate and the offset is an unrealized loss on Bilby's income statement.

When Bilby receives the €1,000,000 payment on February 15, it will have the ability to convert the euros into A$1.517 million (€1,000,000 × A$1.517/€1) at the current spot rate. The difference between the A$1.517 million and recorded year-end receivable of A$1.343 million represents a foreign currency gain.

iii.

If Crane chooses to defer payment until 20X4 and pays in full on February 15, 20X4, Crane, with respect to this transaction, will record:

- a foreign currency loss in 20X4.
- a foreign currency gain in 20X4.
- no foreign currency gain or loss.

Rationale

This Answer is Incorrect

Crane has no foreign currency exposure in its transaction with Bilby; Crane's functional currency is the euro, so it will not recognize any currency transaction gains or losses regardless whether the euro strengthens or weakens.

Rationale

This Answer is Incorrect

Crane has no foreign currency exposure in its transaction with Bilby; Crane's functional currency is the euro, so it will not recognize any currency transaction gains or losses regardless whether the euro strengthens or weakens.

Rationale

This Answer is Incorrect

Crane has no foreign currency exposure in its transaction with Bilby; Crane's functional currency is the euro, so it will not recognize any currency transaction gains or losses regardless whether the euro strengthens or weakens.

iv.

Assume Crane chooses to defer payment until 20X4 and pays in full on February 15, 20X4. If Bilby changes its presentation and recognizes foreign currency transaction gains and losses in other operating income/ expenses, rather than non-operating income/expenses, Bilby's net income on December 31, 20X3 would *most likely* be:

- lower.
- higher.

the same.

Rationale

This Answer is Incorrect

Since the euro depreciated relative to the Australian dollar, Bilby has an unrealized loss on its December 31, 20X3 financial statements. Given the change in presentation, Bilby will report the foreign currency transaction loss as other operating income/expenses rather than non-operating income/ expense for the year-end 20X3. While this will lead to lower operating profit, there will be no impact on net income or gross profit.

Rationale

This Answer is Incorrect

Since the euro depreciated relative to the Australian dollar, Bilby has an unrealized loss on its December 31, 20X3 financial statements. Given the change in presentation, Bilby will report the foreign currency transaction loss as other operating income/expenses rather than non-operating income/ expense for the year-end 20X3. While this will lead to lower operating profit, there will be no impact on net income or gross profit.

Rationale

This Answer is Incorrect

Since the euro depreciated relative to the Australian dollar, Bilby has an unrealized loss on its December 31, 20X3 financial statements. Given the change in presentation, Bilby will report the foreign currency transaction loss as other operating income/expenses rather than non-operating income/ expense for the year-end 20X3. While this will lead to lower operating profit, there will be no impact on net income or gross profit.

Question 43

L2R20TB-AC013-1512

LOS: LOS-7080

Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods

Difficulty: medium

A multinational holding company assigns the parent's presentation currency as the functional currency of its foreign subsidiaries; the translated financial statements *most likely* will translate trade payables using the:

- ○ average exchange rate for the period.
- ○ exchange rate in effect when the liabilities arose.
- ◉ exchange rate in effect at the end of the reporting period.

Rationale

✗ **average exchange rate for the period.**

If the foreign operations use the parent's presentation currency as the functional currency, then the temporal method is applied. Under the temporal method, trade payables, which are a monetary liability, are translated at the current exchange rate.

Rationale

✗ **exchange rate in effect when the liabilities arose.**

If the foreign operations use the parent's presentation currency as the functional currency, then the temporal method is applied. Under the temporal method, trade payables, which are a monetary liability, are translated at the current exchange rate.

Rationale

✓ **exchange rate in effect at the end of the reporting period.**

If the foreign operations use the parent's presentation currency as the functional currency, then the temporal method is applied. Under the temporal method, trade payables, which are a monetary liability, are translated at the current exchange rate.

Question 44
L2FR-TB0026-1412
LOS: LOS-7090
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
Days' sales outstanding of the subsidiary in the presentation currency will *most likely* be:

- Lower under the temporal method than the current method.
- Lower under the current method than the temporal.
- The same for both the temporal method and the current method.

Rationale

This Answer is Correct

Days' sales outstanding is measured as 365 / receivables turnover, where receivables turnover = sales / accounts receivable. Since both methods use the current rate for accounts receivable and the average rate for sales, the ratios will be the same in the presentation currency under both methods.

Question 45
L2R20TB-AC010-1512
LOS: LOS-7050
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium

On December 1, 20X2 ABC Company, a U.S. company that reports its results in U.S. dollars, sells goods to XYZ. The terms of the transaction require that XYZ pay ABC €1,000 within 60 days. ABC's fiscal year-end is December 31, 20X2. Relevant spot exchange rates for foreign currency units per dollar are listed below:

December 1, 20X2	$1 = €0.70
December 31, 20X2	$1 = €0.60
February 1, 20X3	$1 = €0.65

On February 1, 20X3, ABC receives payment in full from XYZ. In its 20X3 financial statements, ABC will *most likely* record:

- (selected) a loss.
- a gain.
- nothing because the amount of the actual realized net gain or loss cancels out the amount of the transaction gain or loss.

Rationale

✅ **a loss.**

When the balance sheet date falls in between transaction inception and transaction close, a foreign currency gain or loss must be recorded at both the fiscal year-end and at the transaction closing date (for the period from the fiscal year-end). ABC has an asset exposure (receivable in euros) from the sale of goods to XYZ and the euro (the foreign currency) depreciated ($1 buys more euros on February 1, 20X3 than it did on December 31, 20X2) in 20X3 between the fiscal year-end and the transaction closing date; this results in a loss because ABC owns a euro- denominated asset and this asset is worth less in dollars on February 1, 20X3 than it was worth on December 31, 20X2 (a gain would have been recognized on December 31 to take account of the appreciation of the euro that occurred from December 1 to December 31). The amount of the foreign currency loss is $128, which is calculated as follows:

$$\text{Gain/Loss} = \left(€1{,}000 \times \frac{\$1}{€0.65}\right) - \left(€1{,}000 \times \frac{\$1}{€0.60}\right) = -128\,(\text{loss})$$

Rationale

❌ **a gain.**

When the balance sheet date falls in between transaction inception and transaction close, a foreign currency gain or loss must be recorded at both the fiscal year-end and at the transaction closing date (for the period from the fiscal year-end). ABC has an asset exposure (receivable in euros) from the sale of goods to XYZ and the euro (the foreign currency) depreciated ($1 buys more euros on February 1, 20X3 than it did on December 31, 20X2) in 20X3 between the fiscal year-end and the transaction closing date; this results in a loss because ABC owns a euro- denominated asset and this asset is worth less in dollars on February 1, 20X3 than it was worth on December 31, 20X2 (a gain would have been recognized on December 31 to take account of the appreciation of the euro that occurred from December 1 to December 31). The amount of the foreign currency loss is $128, which is calculated as follows:

$$\text{Gain/Loss} = \left(€1{,}000 \times \frac{\$1}{€0.65} \right) - \left(€1{,}000 \times \frac{\$1}{€0.60} \right) = -128 \text{ (loss)}$$

Rationale

nothing because the amount of the actual realized net gain or loss cancels out the amount of the transaction gain or loss.

When the balance sheet date falls in between transaction inception and transaction close, a foreign currency gain or loss must be recorded at both the fiscal year-end and at the transaction closing date (for the period from the fiscal year-end). ABC has an asset exposure (receivable in euros) from the sale of goods to XYZ and the euro (the foreign currency) depreciated ($1 buys more euros on February 1, 20X3 than it did on December 31, 20X2) in 20X3 between the fiscal year-end and the transaction closing date; this results in a loss because ABC owns a euro- denominated asset and this asset is worth less in dollars on February 1, 20X3 than it was worth on December 31, 20X2 (a gain would have been recognized on December 31 to take account of the appreciation of the euro that occurred from December 1 to December 31). The amount of the foreign currency loss is $128, which is calculated as follows:

$$\text{Gain/Loss} = \left(€1{,}000 \times \frac{\$1}{€0.65} \right) - \left(€1{,}000 \times \frac{\$1}{€0.60} \right) = -128 \text{ (loss)}$$

Question 46
L2FR-TB0021-1412
LOS: LOS-7050
Lesson Reference: Lesson 1: Defining the Presentation Currency, Functional Currency, Local Currency, and Foreign Currency Transaction Exposure
Difficulty: medium
Which of the following statements regarding the requirements of IFRS and U.S. GAAP with regard to accounting for foreign currency transactions profit and loss is most accurate?

- (selected) Both IFRS and U.S. GAAP require that foreign exchange transaction profit and loss should appear in the income statement.
- U.S. GAAP requires that foreign exchange transaction profit and loss should appear in the income statement, IFRS requires that it be shown in OCI.
- IFRS requires that foreign exchange transaction profit and loss should appear in the income statement, U.S. GAAP requires that it be shown in OCI.

Rationale

This Answer is Correct

Both IFRS and U.S. GAAP require foreign currency transaction gains and losses to be reported in net income, but neither standard indicates where on the income statement these gains and losses should be placed.

Question 47
L2R20TB-AC018-1512
LOS: LOS-7070
Lesson Reference: Lesson 2: Translation of Foreign Currency Financial Statements: The Current Rate and Temporal Methods
Difficulty: medium
Kennedy James is reviewing foreign currency movements and the related impact on the translated financial statements given a specific translation method. The method he determines that results in a higher translated net income when the foreign currency is weakening against the parent company's reporting currency is the:

- ○ current rate method
- ○ temporal method if there is a net monetary asset exposure.
- ◉ temporal method if there is a net monetary liability exposure.

Rationale
✖ **current rate method**
If the foreign currency is weakening, under the temporal method, a net monetary liability exposure will result in a translation gain (as opposed to a loss or a negative adjustment under the other options) and therefore a higher translated net income.

Rationale
✖ **temporal method if there is a net monetary asset exposure.**
If the foreign currency is weakening, under the temporal method, a net monetary liability exposure will result in a translation gain (as opposed to a loss or a negative adjustment under the other options) and therefore a higher translated net income.

Rationale
✔ **temporal method if there is a net monetary liability exposure.**
If the foreign currency is weakening, under the temporal method, a net monetary liability exposure will result in a translation gain (as opposed to a loss or a negative adjustment under the other options) and therefore a higher translated net income.