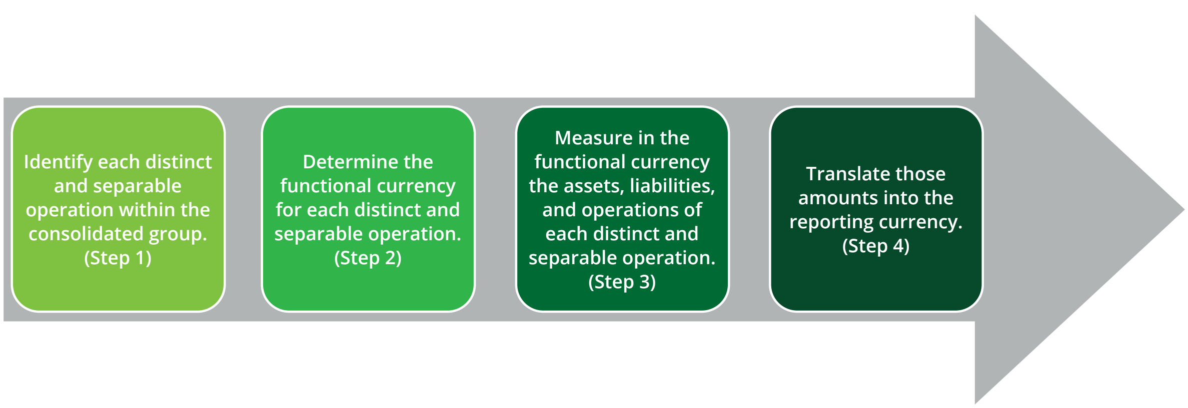
April 2025

On the Radar
Foreign Currency Matters

Many entities operate in multiple countries. When an entity's financial statements include foreign operations, the entity must consolidate those foreign entities and present them as though they were the financial statements of a single reporting entity. This process of translating the accounts of foreign entities is addressed in ASC 830, which has existed for decades without recent substantial changes, and is known as the "functional-currency approach."

Under the functional-currency approach, a reporting entity must perform four steps:



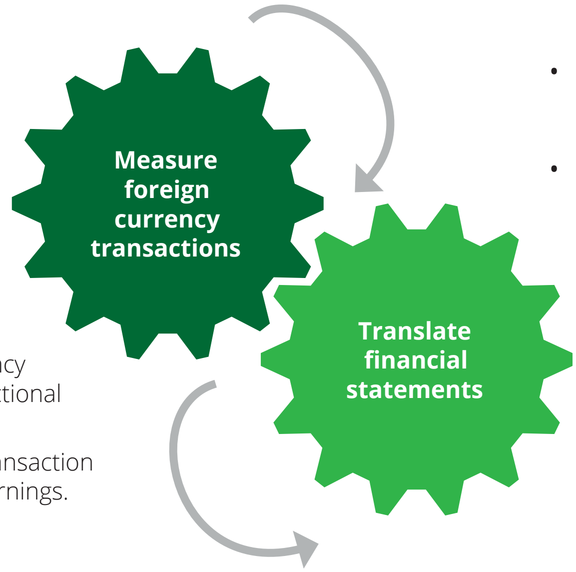
The Functional-Currency Approach

The functional-currency approach comprises the following four steps:

- *Step 1: Identify each distinct and separable operation within the consolidated group* — The first step in the functional-currency approach is to determine which foreign entities make up the reporting entity. To be considered a foreign entity, an operation (or set of operations) should have its own financial statements or be able to produce such statements. Accordingly, a foreign entity most likely would have a management team that uses dedicated resources to run the entity's operations. The concept of "distinct and separable operations" is important to making this determination. While a legal entity may represent a distinct and separable operation, a legal entity could consist of multiple distinct and separable operations (i.e., multiple foreign entities for financial reporting purposes).
- *Step 2: Determine the functional currency for each distinct and separable operation* — Once the distinct and separable operations (i.e., foreign entities) have been identified, the next step is to determine the "currency of the primary economic environment in which each [foreign] entity operates." An entity may be required to use significant judgment in making this determination. Special consideration is required for entities that operate in highly inflationary economies (see further discussion below).
- *Step 3: Measure in the functional currency the assets, liabilities, and operations of each distinct and separable operation* — Foreign currency transactions must be remeasured into an entity's functional currency before those amounts are translated into the parent's reporting currency. Accordingly, an entity must distinguish between monetary and nonmonetary items. Monetary items are remeasured into an entity's functional currency by using a current exchange rate, which generally results in the recognition of gains or losses in earnings. On the other hand, nonmonetary items are remeasured at historical exchange rates; therefore, gains and losses would not be recognized in earnings for such items. An entity may need to use judgment in determining the exchange rate to use for such remeasurements (see further discussion below).
- *Step 4: Translate those amounts into the reporting currency* — The last step is to translate the amounts of foreign entities into the reporting currency, which is generally the functional currency of the entity's parent. This process is performed on a step-by-step basis (i.e., the amounts of third-tier foreign entities are translated into the reporting currency of their immediate parent before the intermediate parent's amounts are translated into the ultimate parent's reporting currency). As is the case with remeasurement, an entity may need to use judgment in determining the exchange rate to use for such translations (see further discussion below).

Common Misconception

It is important to understand the difference between remeasurement and translation under ASC 830, since the applicability of the two concepts differs as does the treatment of the resulting gains and losses. Remeasurement of financial results into the functional currency of a foreign entity involves the presentation of transactions denominated in a currency that differs from the entity's functional currency, and this process generally affects the income statement. Translation simply refers to the process of converting the financial statements from the functional currency into the parent's reporting currency. The effects of translation are reported in equity. For example, an EUR-denominated subsidiary of a U.S. parent would remeasure a JPY-denominated receivable into euros before translating its financial statements into U.S. dollars.



- Translate functional-currency financial results into the reporting currency.
- Recognize the translation adjustment as an unrealized gain or loss within cumulative translation adjustment (CTA).

- Measure foreign currency transactions in the functional currency.
- Generally, recognize transaction gain or loss through earnings.

Special Considerations

Exchange Rates

In remeasuring foreign-currency-denominated transactions into the entity's functional currency and translating financial statements into the parent's reporting currency, an entity must identify the appropriate exchange rate. While ASC 830 provides some guidance on which exchange rates should be used, it may not always be clear that a particular exchange rate is appropriate. Significant judgment may be required when multiple legal exchange rates coexist (e.g., when an official exchange rate and an unofficial exchange rate exist).

Intra-Entity Transactions

Intra-entity foreign currency transactions can have unique effects on an entity's financial statements, including the (1) creation and transfer of foreign currency risk from one entity in a consolidated group to another, (2) creation of transaction gains and losses that "survive" consolidation, and (3) application of exceptions to the general rules outlined in ASC 830. In some situations, the remeasurement of loans between entities within a consolidated group creates transaction gains or losses that are recognized in earnings. In other situations, the remeasurement is recognized within equity.

Highly Inflationary Economies

In economies with significant inflation, the local currency may be deemed unstable. Therefore, ASC 830 requires that entities operating in environments deemed to be highly inflationary remeasure their financial statements into the reporting currency. That is, the reporting currency of the entity's immediate parent is used as the functional currency of the foreign entity. An entity may need to use significant judgment in determining whether a foreign entity operates in a highly inflationary economy. If such an economy is determined to be highly inflationary, the guidance in ASC 830 on applying the functional-currency approach must be applied. The application of such guidance can be time-consuming and complex.

Deloitte's Roadmap *Foreign Currency Matters* comprehensively discusses the scope, measurement, and disclosure guidance in ASC 830.

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