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Foreign Currency - Accounting for Intercompany Transactions

ASC 830 addresses foreign currency matters; it provides accounting and reporting requirements for foreign currency transactions, as well as the translation of financial statements of an entity from a foreign currency to the reporting currency.

ASC 830 also applies to the consolidation of financial statements, specifically the translation of financial statements of a subsidiary denominated in a foreign currency into the reporting currency of the parent.

The first step in foreign currency translation is to identify an entity's functional currency; in many cases, the functional currencies of foreign subsidiaries of the parent company are the local currencies in which those foreign subsidiaries operate.

After the functional currency of each foreign subsidiary has been identified, any account balances not stated in each subsidiary's functional currency should be remeasured into each subsidiary's functional currency. This step may not be necessary for the subsidiaries of a parent company because the functional currencies of the foreign subsidiaries of the parent company may be the local currencies in which those foreign subsidiaries operate.

Once the remeasurement process (if applicable) is complete, the financial statements of each subsidiary must be translated into the reporting currency of the parent company using the current rate method, with the resulting translation adjustments recorded as a separate component of Other Comprehensive Income.

Under the current rate method, assets and liabilities are translated at the exchange rate on the balance sheet date, and income statement items are translated at the exchange rate on the date they are recognized. For practical purposes, a weighted average exchange rate may be used to translate income statement items.

Per ASC 830-20-35-1, a change in exchange rates between the functional currency and the currency in which the transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease is a foreign currency gain or loss that generally should be included in net income for the period in which the exchange rate changes.

ASC 830-20-35-3 states that gains and losses on <u>certain</u> foreign currency transactions should not be included in net income, but should be reported in the same manner as translation adjustments, in other words, as part of Other Comprehensive Income. Those transactions are as follows:

a. Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing on the designation date.
b. Intra-entity foreign currency transactions that are of a long-term investment nature (settlement is not planned or anticipated in the near future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements.

Per ASC 830-20-35-4, examples of transactions or balances for which settlement is not planned or anticipated in the foreseeable future might include balances which take the form of advances or demand notes payable.

The rule addressed in ASC 830-20-35-3, however, is a general one; there are exceptions to that rule. It is important to note that even if no time period is specified for repayment, if eventual settlement is planned, it is presumed that settlement will occur in the foreseeable future. For example, if a US parent company makes a loan to its foreign subsidiary, and the US parent company makes no representations about the loan being indefinite nor about timing for repayment of the loan, it is still presumed that settlement will occur in the foreseeable future if the US parent company foresees circumstances in which it would need to demand repayment (for liquidity reasons, etc.) from the foreign subsidiary.

A company should examine in detail its intercompany accounts to determine whether the accounts represent transactions of a long-term investment nature, considering the business purposes of transactions and the long-term plans related to the intercompany transactions.

When a company has one intercompany account between a parent and a foreign subsidiary through which all intercompany transactions are recorded, the intercompany account may include a combination of trade transactions, short-term financing transactions, as well as long-term investment transactions. Any of these transactions that include a long-term investment component should be identified and separated from other transactions in the account to determine the amount of foreign currency transaction gains and losses to be reported in other comprehensive income.

If a minimum balance is maintained in such an intercompany account, that minimum balance may be considered as part of the parent company's long-term financing of the foreign subsidiary.

In conclusion, the nature of intercompany foreign currency transactions and the resultant accounting for those transactions should be considered on an individual transaction basis. Management should consider each transaction against the backdrop of Management's intent regarding settlement of transactions – regardless of whether there is a specific timeline for settlement.

Furthermore, although an individual transaction of a foreign subsidiary may be considered to be of a long-term investment nature, it should still be accounted for as part of net income on the separate financial statements of the foreign subsidiary (unless those financial statements constitute disaggregated information of the parent). The transaction would then be accounted for as part of other comprehensive income of the US parent.