Compliance ■ Forensic ■ M&A ■ Small Business
701 Palomar Airport Rd, Ste 300 Carlsbad, CA 92011 (760) 707-8535

**05/21/15**

## ASC 830 – Foreign Currency Matters
## Determination of Functional Currency

The SEC does not require a registrant to disclose how it determined the functional currency of its foreign operations. However, several of the nation's top accounting firms recommend that a registrant document its functional currency selection pursuant to ASC 830.

A quick Google search will produce at least one instance during the past few years in which the SEC requested that a registrant justify its functional currency selection.

ASC 830 addresses foreign currency matters; it includes provisions which address the remeasurement and translation of foreign currency statements, and stresses the importance of determining the functional currency for a company's foreign entity. Determining the functional currency of a foreign entity is necessary in order to apply the remeasurement and translation provisions of ASC 830.

ASC 830-10-45-2 states that an entity's functional currency is the currency of the primary economic environment in which the entity operates. It is generally the currency of the environment in which an entity primarily generates and expends cash. To assist in the identification of an entity's functional currency, ASC 830-10-45-4 describes two broad classes of foreign operations: one for which the foreign currency is the functional currency, and the other for which the parent's currency is the functional currency.

The first class of foreign operations includes those operations that are relatively autonomous and integrated within a particular country or economic environment. The daily operations of the foreign entity are independent from the economic environment of the parent's functional currency. The foreign operation's cash flows are primarily received and paid in a foreign currency and do not directly affect the parent's cash flows, but those cash flows may be reinvested or converted and distributed to the parent. In this case, the foreign currency is the functional currency for the foreign operation.

The second class of foreign operations includes those operations that are primarily a direct extension or integral component of the parent company's operations. Significant assets may be acquired from the parent, or the sale of assets may generate dollars that are available to the parent. The foreign operation's cash flows are primarily in the parent company's functional currency. Its daily operations are integrated with the parent's operations, and the foreign entity's cash flows directly affect the parent's cash flows. In this case, the parent's functional currency is the functional currency of the foreign operations.

Frequently, an entity's foreign operations do not clearly match one of the class descriptions above, and in fact operations will exhibit characteristics of both classes. In this case, management must apply judgment to determine the appropriate functional currency to use; at the same time, functional currency selection is a factual matter, and management must examine the facts of operations.

Per ASC 830-30-10-55-5, there are six economic indicators for management to consider in determining the functional currency for a foreign entity. Note that ASC 830 does not rank or weight the indicators, therefore management should use judgment to determine which indicators are most relevant to the foreign operations and the economic environment in which it operates.

The indicators are as follows:

**Cash flow indicators**
- Foreign currency: Cash flows related to the foreign entity's individual assets and liabilities are primarily in the foreign currency and do not directly affect the parent entity's cash flows.

- Parent's currency: Cash flows related to the foreign entity's individual assets and liabilities directly affect the parent's cash flows currently and are readily available for remittance to the parent entity.

**Sales price indicators**

- Foreign currency: Sales prices for the foreign entity's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.
- Parent's currency: Sales prices for the foreign entity's products are primarily responsive on a short-term basis to changes in exchange rates; for example, sales prices are determined more by worldwide competition or by international prices.

**Sales market indicators**

- Foreign currency: There is an active local sales market for the foreign entity's products, although there also might be significant amounts of exports.
- Parent's currency: The sales market is mostly in the parent's country or sales contracts are denominated in the parent's currency.

**Expense indicators**

- Foreign currency: Labor, materials, and other costs for the foreign entity's products or services are primarily local costs, even though there also might be imports from other countries.
- Parent's currency: Labor, materials, and other costs for the foreign entity's products or services continually are primarily costs for components obtained from the country in which the parent entity is located.

**Financing indicators**

- Foreign currency: Financing is primarily denominated in foreign currency, and funds generated by the foreign entity's operations are sufficient to service existing and normally expected debt obligations.
- Parent's currency: Financing is primarily from the parent or other dollar-denominated obligations, or funds generated by the foreign entity's operations are not sufficient to service existing and normally expected debt obligations without the infusion of additional funds from the parent entity. Infusion of additional funds from the parent entity for expansion is not a factor, provided funds generated by the foreign entity's expanded operations are expected to be sufficient to service that additional financing.

**Intra-entity transactions and arrangements indicators**

- Foreign currency: There is a low volume of intra-entity transactions and there is not an extensive interrelationship between the operations of the foreign entity and the parent entity. However, the foreign entity's operations may rely on the parent's or affiliates' competitive advantages, such as patents and trademarks.
- Parent's currency: There is a high volume of intra-entity transactions and there is an extensive interrelationship between the operations of the foreign entity and the parent entity. Additionally, the parent's currency generally would be the functional currency if the foreign entity is a device or shell corporation for holding investments, obligations, intangible assets, and so forth, that could readily be carried on the parent's or an affiliate's books.

The above factors should be addressed in consideration of the long-term operations of the foreign entity, which will help the parent company avoid the possibility of making frequent changes to a foreign entity's functional currency.

It is important to note that ASC 830-10-55-7 specifies that a foreign operation's functional currency may not necessarily be that of its parent simply because the parent controls it. At the same time, even though the parent's currency may be used in certain decisions made by management, it does not necessarily mean that the parent's currency is the functional currency for the foreign operation. The standard specifies that the economic factors described here should be used to make the determination about a foreign operation's functional currency.