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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 June 2008, London**

Project: **Financial Statement Presentation**

Subject: **Foreign currency and basket transactions (Agenda Paper 9C)**

INTRODUCTION

1. An **objective of the June 2008** Board meeting on financial statement presentation is to address and resolve what should be included in the preliminary views document about presenting foreign currency gains and losses and allocating the effects of basket transactions[1].

ISSUE 1: PRESENTING FOREIGN CURRENCY GAINS AND LOSSES IN THE STATEMENT OF COMPREHENSIVE INCOME

2. Both FASB Statement No. 52, *Foreign Currency Translation*, and IAS 21, *The Effects of Changes in Foreign Exchange Rates*, require that an entity include in earnings (for entities applying U.S. GAAP) or profit or loss (for entities applying

[1] This paper contains illustrations and examples which are presented for discussion purposes only and should be read only in the context of the meeting papers. Not all aspects of the illustrations and examples have been discussed by or represent the current position of the Boards (and those that have are subject to change).

IFRSs) the gain or loss resulting from remeasuring foreign currency transactions and foreign currency financial statements into the entity's functional currency. (Both Statement 52 and IAS 21 provide specified exceptions to that requirement in which a particular transaction gain or loss in included in OCI rather than in earnings or profit or loss. Those exceptions will be classified in the same way as other OCI items.) Both standards also require an entity to include translation adjustments resulting from translating an entity's functional currency financial statements into the reporting currency (FCTAs) in OCI and to reclassify the accumulated FCTAs to earnings or profit or loss upon disposal of the foreign operation.

3. The Boards addressed the classification and presentation of FCTAs in October 2007. At that meeting, the Boards decided that FCTAs should be presented in a separate section. As a result of the Boards' decision to exclude the existing presentation guidance on OCI and the related reclassification adjustments from the scope of this project, the preballot draft no longer contains the Boards' preliminary view that FCTAs should be presented in a separate section. However, for the preliminary views document to be complete on foreign currency items, the staff is of the view that the document should include guidance on the classification of other foreign currency gains and losses. Therefore, this memorandum addresses the classification of foreign currency transaction gains and losses and remeasurement gains and losses.

Transaction Gains and Losses

4. Achieving the cohesiveness objective would require that a gain or loss on a transaction denominated in a foreign currency be presented in the same section and category as the asset or liability that gave rise to it. For example, if the U.S. dollar entity has €1,000,000 of Euro-denominated debt, and the rate changes from €1 = $1.49 to € =$1.58 during the year, the entity's exchange loss of $90,000 is easy to compute ($1,490,000 - $1,580,000). If the debt is classified in the nonowner financing section of the statement of financial position, the entity would include that loss in the nonowner financing section of the statement of comprehensive income.

Net Exchange Gains or Losses

5. An entity might have a subsidiary that operates in a foreign location and keeps its books of record in a currency other than the functional currency. The foreign entity's monetary assets and liabilities will be remeasured into functional currency using the exchange rate at the end of the year. The related income and expense items can be remeasured using a weighted average exchange rate to approximate the amounts that would result if each individual items were remeasured using the rate of the date it occurred. That remeasurement process will result in a net transaction gain or loss to be included in earnings or profit or loss.

6. The staff considered three alternatives for presenting the resulting exchange gain or loss.

   a. Classify the components of the net exchange gain or loss on remeasuring an entity's local currency financial statements into its functional currency in the same sections and categories as the assets and liabilities that gave rise to the net gain or loss.

   b. Present the net transaction gain or loss in a single category, such as the operating category or the financing category. This could be based on the category that gave rise to the greatest portion of the gain or loss or an arbitrary assignment determined by the Boards.

   c. Present the net transaction gain or loss in a separate category, similar to the Boards' preliminary view on FCTAs.

7. Determining the components of the net transaction gain or loss on remeasurement of foreign currency financial statements to classify in the appropriate sections or categories in the statement of comprehensive income will be more difficult than simply including the gain or loss on an individual foreign-currency denominated item in the same category as the asset or liability that gave rise to it. However, the staff observes that Statement 52 and IAS 21 make no conceptual distinction between the gain or loss on an individual item denominated in a foreign currency and the net transaction gain or loss on foreign currency financial statement. Thus,

the staff is of the view that if the gain or loss on the Euro-denominated debt is to be included in the same category as the debt that gave rise to it. The net gain or loss on remeasuring the foreign financial statements also should be broken down into its components and classified into the corresponding sections and categories. In addition, presenting all of the gain or loss in a single category would result in information that is not representationally faithful if part of the amount resulted from items classified in other categories. The staff also observed that presenting the net gain or loss in a separate section could be misleading if the gain or losses on individual foreign-currency transactions were classified in other categories.

8. Separating the components of the net exchange gain or loss into the amounts related to assets and liabilities in different sections and categories is not necessarily a matter of allocation, per se. As illustrated in the following example, the presented amount in a particular section or category can be determined directly by applying the amount of the rate change during the period to the net assets or liabilities in that category and the related income or expense amounts.

9. For purposes of this illustration, assume that all transactions occurred evenly throughout the year, except for purchasing inventory which occurred at the beginning of the year. Therefore, it is appropriate to use an average rate when remeasuring income and cash flow items, except cost of goods sold which is remeasured using the historical rate. Finally, assume that the ending inventory balance represents only inventory that was purchased during the year.

Assumptions

	2010
Historical rate (HR)	0.77
Current rate (CR)	0.73
Average rate (AR)	0.75
Tax Rate	0.30

Transactions

	2010 Dr	2010 Cr
Purchase Inventory		
Inventory	24,854	
Cash		24,854
Sales		
Accounts Receivable	42,000	
COGS	32,000	
Sales		42,000
Inventory		32,000
Collect cash		
Cash	45,000	
Accounts receivable		45,000
Taxes		
Tax expense	2,565	
Taxes payable		2,565
Taxes payable	1,972	
Cash		1,972
Interest		
Interest expense	1,450	
Debt	3,550	
Cash		5,000

Financial Statements

Financial Position	2010 Local	2010 Functional		YOY Change
Operating				
Accounts receivable	17,000	12,410	CR	(2,990)
Inventory	20,908	16,099	HR	(6,344)
Total operating assets	37,908	28,509		(9,334)
Financing				
Cash	38,028	27,760	CR	8,622
Debt	(27,950)	(20,404)	CR	3,852
Net financing assets	10,078	7,357		12,474
Income Taxes				
Taxes payable	(641)	(468)	CR	(431)
Net Assets	47,345	35,398		2,709
Equity	47,345	35,398		2,709
	-	-		

Financial Position	2009 Local	2009 Functional	
Operating			
Accounts receivable	20,000	15,400	CR
Inventory	28,054	22,443	HR
Total operating assets	48,054	37,843	
Financing			
Cash	24,854	19,138	CR
Debt	(31,500)	(24,255)	CR
Net financing assets	(6,646)	(5,117)	
Income Taxes			
Taxes payable	(49)	(37)	CR
Net Assets	41,360	32,689	
Equity	41,360	32,689	
	-	-	

Comprehensive Income	Local	Functional	
Operating			
Sales	42,000	31,500	AR
COGS	(32,000)	(24,640)	HR
FX Gain/Loss		**(1,582)**	***A**
Total Operating income	10,000	5,278	
Financing			
Interest expense	(1,450)	(1,117)	AR
FX Gain/Loss		**457**	***B**
Income before taxes	8,550	4,619	
Income taxes	(2,565)	(1,924)	AR
FX Gain/Loss		**14**	***C**
Net Income	5,985	2,709	

FX Gain/Loss calculation and assignment to categories

	2010	
***A**	**(1,582)**	$=-9{,}334-\underbrace{(31{,}500-24{,}640)+14{,}612}_{\text{Operating income before FX}}$
***B**	**457**	=12,474-3,750+1,117-9,383
***C**	**14**	=-431-1,479+1,924
	(1,110)	$=\underbrace{2{,}709}_{\text{Change in net assets}}-\underbrace{(31{,}500-24{,}640-1{,}117-1{,}924)}_{\text{Comprehensive income before FX}}$

Cash Flows	Local	Functional	
Operating			
Cash received from customers	45,000	33,750	AR
Cash purchases of inventory	(24,854)	(19,138)	HR
Total operating cash flows	20,146	14,612	
Financing			
Cash paid on debt	(5,000)	(3,750)	AR
Cash Taxes paid	(1,972)	(1,479)	AR
Net Cash Flow	13,173	9,383	
Beginning cash	24,854		
Ending cash	38,028		

10. Because the statements are cohesive across categories, an entity should be able to determine the net exchange gain or loss for each category in substantially the same way it would determine the net exchange gain or loss for the entire entity. The staff is of the view that assigning remeasurement gains and losses to the categories that give rise to them in the statement of comprehensive income provides more useful information regarding foreign exchange gains and losses and would not represent an overly onerous change over what is currently required.

Staff Recommendation

11. The staff recommends that the preliminary views document contain the following principle and seek comment from respondents:

> **An entity should display transaction gains and losses, including the components of the net gain or loss on remeasuring the financial statements of an entity into its functional currency, in the same section and category as the assets or liabilities that gave rise to the gains or losses.**

Question for the Boards

Q1. Do the Boards agree with the above staff recommendation?

ISSUE 2: ALLOCATING THE EFFECTS OF BASKET TRANSACTIONS

12. In October 2007, the Boards were asked to express a preliminary view on the presentation of gains/losses and cash flows that result from single transactions that involve the purchase or disposal of multiple assets, or a combination of assets and liabilities, that are classified in more than one category under the working format (herein, referred to as basket transactions).

13. The IASB decided that the effects of basket transactions should be allocated to the multiple categories and asked the staff to develop an allocation method (or two) to present in the preliminary views document. Some IASB Board members noted that supplementary disclosure would be helpful if the effects of basket transactions were allocated. The FASB did not make a decision related to the allocation of effects of

basket transactions but asked the staff to come back with the allocation methods so that the Board can make a decision at a future meeting.

14. Paragraphs 3.63 and 3.69 of the May 30 preballot draft (see below) reflects the staff's recommendation on the presentation of basket transactions (the staff acknowledges that the language below could be improved):

> 3.63 **An entity should allocate the income and cash flow effects of basket transactions to the sections and categories in which the related assets or liabilities appear based on the relative fair values of the assets and liabilities involved in the transaction.**
>
> 3.69 Although the Boards did not discuss a precise "relative fair value" allocation methodology, they indicated that the allocation method or process should reflect the main purpose of the basket transaction. For example, if the primary purpose is to dispose of assets, the difference between the amount of cash or other consideration received and the net fair value of the individual assets and liabilities disposed of represents the gain or loss on the transaction. That gain or loss would be allocated to sections and categories in the statement of comprehensive income based on the relative fair values of the noncash assets acquired, and none of the gain or loss would be allocated to liabilities assumed or cash acquired. An entity would allocate net cash flows in a similar manner, which would avoid "grossing up" the cash flows associated with a basket transaction.

15. The staff is of the view that any further discussion of disclosures related to basket transactions should be held during the Exposure Draft stage of this project. Thus, the preballot draft does not address (or illustrate) supplementary disclosures that might be helpful if the effects of basket transactions are allocated.

Allocation Based on Relative Fair Values

16. The general principle in allocating the effects of basket transactions is to allocate the transaction amount used to determine the gains and losses and the cash flows based on relative fair values of the assets and liabilities involved in the transaction. The staff is of the view that this is the most reasonable basis for allocation and is consistent with existing standards (such as the business combination standards). However, the staff is of the view that there should be exceptions for liabilities and cash, which are discussed below.

No Relative Fair-Value Allocation to Liabilities

17. For illustration purposes, consider the disposal of the following set of assets and liabilities for a consideration (measured at fair value) of $120:

	Carrying amount	Fair value
Operating assets	140	150
Financing liabilities	(40)	(50)
Total	100	100

Based on this example, there are two ways to allocate the $120:

Alternative 1: Proportionately allocate the amount to assets and liabilities based on *the relative magnitude of their fair values*. Any difference between the allocated transaction amount and the carrying amount would be recognized as a gain or loss; a gain or loss may be recognized for a liability even when the carrying amount of the liability equals the fair value of that liability.

Based on Alternative 1, gains and losses are calculated as follows:

	Carrying amount	Fair value	Allocated amount	Gain/Loss
	(a)	(b)	(c)	(d)=(c)-(a)
Operating assets	140	150	180	40
Financing liabilities	(40)	(50)	(60)	(20)
Total	100	100	120	20

Alternative 2: First allocate to cash the carrying amount and liabilities their fair values. Second, allocate the remaining transaction amount non-cash assets based on their *relative fair values*. The amounts allocated to liabilities would be their fair values. Any difference between the allocated amount and the carrying amount would be recognized as a gain or loss; if the carrying amount of the liability equals the fair value of that liability, no gain or loss would be recognized.

Based on Alternative 2, gains and losses are calculated as follows:

	Carrying amount	Fair value	Allocated amount	Gain/Loss
	(a)	(b)	(c)	(d)=(c)-(a)
Operating assets	140	150	170	30
Financing liabilities	(40)	(50)	(50)	(10)
Total	100	100	120	20

18. The staff is of the view that the amount used to determine the gains and losses should not be allocated to liabilities on a relative fair value basis only. Rather, the amount allocated for liabilities should be the fair value of the liabilities. The staff is of the view that Alternative 1 unnecessarily magnifies the gains and losses in each category.

No Relative Fair-Value Allocation to Cash

19. The staff is of the view that the amount used to determine the gains and losses should not be allocated to cash based on relative fair values. If the amounts were allocated based on relative fair values, there is a possibility that amounts allocated to cash would become larger or smaller than the actual cash flows. In order to avoid this contradiction, the staff is of the view that any cash involved in the transaction should be netted against the transaction amount.

Allocating Cash Flows to Each Category in a Basket Transaction

20. The staff is of the view that cash flows should be allocated based on the relative fair value of the assets disposed of. No cash flows would be allocated to liabilities in order to avoid creating hypothetical cash flows. Assuming that all consideration was cash in the example above, $120 would be allocated to the operating section and no cash flows would be allocated to financing section.

Presentation Under a No-allocation Approach

21. The staff is of the view that the preliminary views document should discuss possible presentations if the effects of basket transactions are not allocated. As such the staff included the following paragraphs in the preballot draft based on the memorandum prepared for the October 2007 meetings:

3.70. The Boards considered the following alternatives for presenting the effects of basket transactions if the effects are not to be allocated:

Alternative A: Present in the operating category.

Alternative B: Present in the category that reflects the activity that was the predominant source of those effects.

Alternative C: Present in a separate section.

3.71. Alternative A would be easy to implement and could be viewed as a practical expedient because it is likely that, even if the effects are allocated to or classified in categories, most of the effects would be presented in the operating category. Alternative B is consistent with the guidance in paragraph 2.29 that an entity should classify an asset or liability that serves more than one function based on its predominant purpose. Not allocating the effects of basket transactions to the sections and categories (Alternative C) would introduce an exception to the cohesiveness objective, but it would present that exception in a prominent manner. On balance, however, the Boards concluded that allocating the effects of basket transactions to the appropriate sections and categories would be preferable to those other alternatives.

Question for the Boards:

Q2. Do the Boards agree that amounts allocated to determine gain or loss should be based on the relative fair value of non-cash assets?

Q3. Do the Boards agree that no hypothetical cash flows should be allocated to liabilities in a basket transaction?

Q4. Do the Boards agree that alternatives for not allocating the effects of basket transactions should be discussed in the preliminary views document?

Q5. Do the Boards agree that the Boards' leaning should not be provided for these alternatives?