Multinational Operations

Test ID: 7440447

Question #1 of 154

Question ID: 462300

Which of the following statements describing the choice of the functional currency is *least* accurate? The functional currency should be the same as the parent's reporting currency if the subsidiary is:

✗ **A)** **highly integrated with the parent where the local currency, prices, and some costs are controlled or restricted.**

✓ **B)** mostly independent from the parent.

✗ **C)** highly integrated with the parent where the local currency, prices, and some costs are not controlled or restricted.

Explanation

The preferred functional currency for subsidiaries that are mostly independent of the parent is the local currency. For highly integrated subsidiaries (regardless of local conditions), or for subsidiaries operating in high-inflation environments, the parent's reporting currency should be used as the functional currency.

Question #2 of 154

Question ID: 462354

Which of the following statements regarding the translation of a foreign subsidiary into the reporting currency is *most* accurate?

✓ **A)** **If the reporting currency is the functional currency, the temporal method is applied and exposure is equal to net monetary assets.**

✗ **B)** A multinational firm with small liability balances generally has minimal foreign currency exposure on its balance sheet.

✗ **C)** If the functional currency is equal to the local currency, exchange gains and losses on translation will be recognized in the income statement.

Explanation

The choice of functional currency is the determining factor as to which method of foreign currency translation is utilized. Therefore, when the reporting currency is the functional currency, the temporal method must be used. The choice of functional currency is largely left to management's discretion.

Question #3 of 154

Question ID: 462458

In a hyperinflationary economy, translation under the current rate method will *most likely* result in relatively:

✓ **A)** **low balance sheet values for long term liabilities.**

✗ **B)** high balance sheet values for long term assets.

✗ **C)** high translation gains.

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency.

Explanation

The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

In a hyperinflationary economy, translation under the current rate method will *most likely* result in relatively low balance sheet values for assets and liabilities. Translation losses will also occur.

Since the USD is the functional currency, use the temporal method. Under the temporal method, inventory is remeasured using the historical rate. However, our best guess of the historical rate under the weighted average inventory cost-flow assumption is the average rate through the period. Hence, A/R = $0.615 × 3,000 = $1,845 and Inventory = $0.6002 × 4,000 = $2,401.

Question #4 of 154

Question ID: 462357

Under the temporal method, the inventory and cost of goods sold (COGS) accounts are both nonmonetary accounts. Which of the following statements is *least* accurate regarding these accounts?

✗ **A) The Inventory account is remeasured using the historical rate under both LIFO and FIFO.**

✗ **B)** If the firm accounts for inventory using first in, first out (FIFO), then a more recent rate will be applied to the inventory account.

✓ **C)** If the firm accounts for inventory using last in, first out (LIFO), then the beginning-of-period rate is used to remeasure COGS.

Explanation

The monetary asset and liability accounts under the temporal method are cash, accounts receivable, accounts payable, and long-term debt.

Under LIFO, the last goods purchased are the first goods out to COGS. Hence, although technically the *historical rate* is used to remeasure COGS, a more recent rate is typically more appropriate for COGS under LIFO.

Question #5 of 154

Question ID: 462468

A company is exposed to foreign exchange risk due the impact of changes in currency values on a:

✗ **A) company's assets only.**

✗ **B)** company's assets and liabilities only.

✓ **C)** company's assets, liabilities and future sales.

Explanation

Explanation

Foreign exchange risks include the impact of changes in currency values on assets and liabilities of a business, as well as on future sales.

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency.

The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Questions #6-11 of 154

Hise Home Supply is a large, profitable home improvement retailer located in the United Kingdom. Hise has recently been acquiring niche retailers with popular brand names in certain segments of the home improvement market. One of these retailers was Wilson Tile and Stone, a U.S. business that derived a large part of its sales from the UK.

The management team for Hise now makes all operating, financing, and investment decisions. Brian Heltzel, a financial analyst for Hise, is responsible for translating Wilson's financial statements from U.S. dollars to the reporting currency. Hise conducts its business and issues financial statements in British pounds (£). Extracts from the financial statements of Wilson are shown below in exhibit one.

Exhibit One - Wilson Financial Statement Extracts

Wilson Tile and Stone - December 31, 2007 and 2008 Balance Sheets		
	2007	**2008**
Cash	$1,200	$1,400
Accounts receivable	6,500	9,900
Inventory	10,400	12,400
Current assets	$18,100	$23,700
Fixed assets	40,000	40,000
Accumulated depreciation	10,000	15,000
Net fixed assets	$30,000	$25,000
TOTAL ASSETS	$48,100	$48,700
Accounts payable	$5,000	$6,000
Current portion of LT debt	1,500	1,500
Long term debt	25,000	23,500
Total liabilities	$31,500	$31,000
Common stock	10,000	10,000
Retained earnings	6,600	7,700
Total equity	$16,600	$17,700
TOTAL LIABILITIES and EQUITY	$48,100	$48,700

Wilson Tile and Stone - 2008 Income Statement	
Revenue	$75,000
Cost of goods sold	(60,000)
Gross margin	$15,000
Other expenses	(2,300)
Depreciation expense	(5,000)
Net Income	$7,700

Wilson uses the FIFO method for inventory accounting.

Applicable exchange rates are as follows:

- December 31, 2007: £1.00 = $1.60

- December 31, 2008: £1.00 = $1.80
- Average for 2008 = £1.00 = $1.70
- Historical rate for fixed assets, inventory, and equity: £1.00 = $1.50

Heltzel is also using some information that has been provided by the accounts department of Wilson. He made the notes shown below in exhibit two from an e mail the accounts department sent.

Exhibit Two - Accounting Department Notes

2008 income before remeasurement gain/loss	£4,138
Dividends paid during the year	£2,250
Opening retained earnings	£5,150
Ending retained earnings	£7,323

Hertzel has also discussed the future of Wilson's role in the group with board members from both Wilson and Hise. These discussions have raised two specific concerns as outline below.

Concern One

Heltzel is concerned about the method used to perform the translation. He is of the opinion that in the future Wilson may become much more independent and begin to function autonomously. To get an idea of the potential accounting impact, he intends to recalculate Wilson's translated numbers this year based on the subsidiary being fully autonomous.

Concern Two

Wilson's board have warned Heltzel that they are likely to engage in transactions next year which will lead to significant deferred revenue balances remaining on the balance sheet at the year end.

Question #6 of 154

Question ID: 462438

As Heltzel is translating the balance sheet and income statement, which of the following are closest to the values Heltzel determines for revenues and accounts payable for 2008?

	Revenues	Accounts Payable
✓ A)	**£44,118**	**£3,333**
✗ B)	£44,118	£3,529
✗ C)	£41,667	£3,333

Explanation

Since the British pound is the functional currency, the temporal method should be used. Under both the current rate and temporal methods, revenues are translated at the average rate. The value Heltzel will calculate for revenues is $75,000 / $1.70 = £44,118.

Also, under both the temporal and current rate methods, monetary assets and liabilities are calculated using the current exchange rate. The value Heltzel will calculate for accounts payable will be $6,000 / $1.80 = £3,333.

(LOS 21.d)

Inventory	300	300
Net Fixed Assets	700	600
Total Assets	*1,600*	*1,700*
Accounts payable (A/P)	100	200
Long-term debt	200	100
Common Stock	1,300	1,300
Retained Earnings	0	100
Total Liabilities	*1,600*	*1,700*

Income Statement (in SF thousands)

December 31, 2013

Question #7 of 154

Question ID: 462439

If Wilson assumes the numbers in exhibit two are correct, the remeasurement gain/loss for 2008 will be closest to:

✗ **A) £1,012.**

✗ **B)** -£77.

✓ **C)** £285.

Assume that the functional currency is the U.S. dollar when answering the following questions.

Explanation

Net income = ending retained earnings − beginning retained earnings + dividends paid.

Question #46 of 154

Question ID: 462322

Net income = 7323 − 5150 + 2250 = £4423.

The level of long-term debt on the 2013 balance sheet is *closest* to:

Remeasurement gain = net income − net income before remeasurement gain = 4423 − 4138 = £285.

✗ **A) $80.**

(LOS 21.e)

✓ **B)** $85.

Question #8 of 154

Question ID: 462440

After remeasurement, what will be the impact on Wilson's quick ratio and accounts receivable turnover ratios respectively for 2008?

	Quick Ratio	Accounts Receivable Turnover
✓ **A)**	**No change**	**Increase**
✗ **B)**	Increase	Increase
✗ **C)**	No change	Decrease

Question #47 of 154

Question ID: 462323

Explanation

After remeasurement, depreciation will be *closest* to:

The quick ratio takes (cash + accounts receivable) / (current liabilities). Since all of these items are monetary assets and liabilities, they are all remeasured at the current exchange rate, resulting in no change to the ratio.

✓ **A) $77.**

✗ **B)** $85.

✗ **C)** $80.

The accounts receivable turnover ratio is calculated as (sales / accounts receivable). Note that the local currency (the U.S. dollar) is depreciating (it takes more $ to buy a pound). Since sales is remeasured at the average rate and accounts receivable is remeasured at the current rate, the depreciating currency means that the remeasured denominator will be smaller than the remeasured numerator, resulting in a larger ratio.

Explanation

(LOS 21.f)

Expenses related to assets translated at historical exchange rate, (e.g., cost of goods sold; depreciation; amortization) are translated at historical rates under the temporal method. Thus under the temporal method we should use the historical rate to

Question #9 of 154

Question ID: 462441

If Heltzel recalculates the translation assuming the change in management as discussed in concern one, Wilson's gross profit margin will be:

✓ **A) Higher under the new management method Heltzel predicts and total asset turnover higher**

✗ **B)** Lower under the new management method Heltzel predicts and total asset turnover lower

✗ **C)** Higher under the new management method Heltzel predicts and total asset turnover lower

Explanation

Common stock is translated using the historical rate under both the temporal method and the current rate method: 1300SF × 0.77$/SF = $1001.

Wilson's gross profit margin (gross profit / sales) will be lower under the temporal method. Sales under both methods are converted at the average rate, while COGS is converted at the historical rate under the temporal method (note FIFO inventory accounting). Since the local currency (the U.S. dollar) is depreciating, COGS will be higher under temporal method, resulting in a lower gross profit and a lower gross profit margin under the temporal method, and hence higher under the current rate method.

Wilson's total asset turnover ratio (sales / total assets) will be higher under the current rate method. Non-monetary assets are converted at the historical rate using the temporal method and the current rate under the current rate method. The depreciating local currency means that total assets will be lower under the current rate method. The lower denominator will lead to a higher total asset turnover ratio under the current rate method

(LOS 21.f)

Explanation

Question #10 of 154

Question ID: 462442

Which of the following treatments is most likely correct regarding the items outlined in concern two?

✓ **A) The balance should be translated at the historic rate as it is a non-monetary item**

✗ **B)** The balance should be translated at the closing rate as it is a monetary item

✗ **C)** The balance should be translated at the historic rate as it is a monetary item

Explanation

Deferred revenue is a non-monetary liability and should be translated at the historic rate.

(LOS 21.d)

Question #11 of 154

Question ID: 462443

Which of the following statements regarding the treatment of subsidiaries in a hyper-inflationary environment under U.S. GAAP is most likely correct?

✗ **A) The subsidiary should be translated using the temporal method regardless of the level of autonomy, and non-monetary items restated for the effect of local inflation**

✓ **B)** The subsidiary should be translated using the temporal method regardless of the level of autonomy, and then no further restatement is required

✗ **C)** The subsidiary should be translated using the current rate method regardless of the level of autonomy, and non-monetary items restated for the effect of local inflation

Explanation

U.S. GAAP requires the use of the temporal method.

(LOS 21.g)

Questions #12-17 of 154

Explanation

If Wilson becomes independent, then the current rate method would be used rather than the temporal method.

(LOS 21.e)

Question #49 of 154

Question ID: 462325

For Scud Co. under the temporal method, the monetary exposures and the foreign currency movements resulted in a:

✗ **A) cumulative translation adjustment gain on the balance sheet**

✗ **B)** remeasurement loss on the income statement.

✓ **C)** remeasurement gain on the income statement.

Explanation

Question #50 of 154

Question ID: 462326

If the functional currency is the Swiss franc and the retained earnings for Scud Co. as of 12/31/2013 is $80,000, the exchange

Balance Sheet	2013 (SF)	Rate($/SF)	2013 ($)
Cash & accounts receivables (A/R)	600	0.85	510
Inventory	500	0.85	425
Net Fixed Assets	600	0.85	510
Total Assets	1,700		1,445

Giant Company is a U.S. firm that produces parts for nuclear reactors. Giant Company has a subsidiary, Grande, Inc., that operates in Mexico and is responsible for designing and manufacturing connection fittings that are vital for the proper operation of its parent company's reactors.

- Giant Company considers the U.S. dollar to be the functional currency of Grande, Inc.
- Grande, Inc., began operations January 1, 2001.
- Common Stock and Fixed Assets were acquired January 1, 2000.
- Inventory is accounted for under the last in, first out (LIFO) cost flow assumption, and was purchased evenly through the year.
- The inventory in the January 1, 2001, Balance Sheet was acquired on January 1, 2001.

Exchange Rates were:	January 1, 2000	$0.14/M peso
	January 1, 2001	$0.12/M peso
	June 30, 2001	$0.11/M peso (this is the 2001 average rate)
	December 31, 2001	$0.10/M peso

Grande, Inc.

Balance Sheet (in M Pesos)

	Jan. 1, 2001	*Dec. 31, 2001*
Cash	5,000,000	20,000,000
Accounts Receivable	20,000,000	35,000,000
Inventory	15,000,000	15,000,000
Fixed Assets (net)	70,000,000	60,000,000
Accounts Payable	10,000,000	10,000,000
Long Term Debt	40,000,000	35,000,000
Common Stock	80,000,000	80,000,000
Retained Earnings		5,000,000

2001 Income Statement

(in M Pesos)

Sales	60,000,000
Cost of Goods Sold	(45,000,000)
Depreciation	(10,000,000)

Net Income	5,000,000

Question #12 of 154

Question ID: 462382

Giant Company should use the following method to reflect the results of Grande, Inc., in its financial statements:

✗ **A) the temporal method followed by the current rate method.**

✗ **B)** the current rate method.

✓ **C)** the temporal method.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency. The temporal method is used when the functional currency is the parent's currency. (Study Session 6, LOS 21.d)

Question #53 of 154

Question ID: 462460

Which of the following asset or liability values is likely to be the *most* understated in a hyperinflationary economy if translation occurs under the current rate method?

Question #13 of 154

Question ID: 462383

The Cost of Goods Sold for Grande, Inc., for the year ended December 31, 2001, expressed in U.S. dollars is:

✓ **A) $4,950,000.**

✗ **B)** $5,400,000.

✗ **C)** $5,250,000.

Explanation

Both the beginning and ending inventory under LIFO cost flow assumptions are translated at the $0.12 rate as of the date the original inventory was acquired, January 1, 2001. Because beginning and ending inventories expressed in Mexican pesos are equal, the purchases for the year will equal the Cost of Goods Sold, which is remeasured at the average cost of acquiring the goods during the year: $0.11. (45,000,000 × $0.11) = $4,950,000. The average rate is the best estimate of the historical rate because the inventory that was sold was purchased evenly through the year. (Study Session 6, LOS 21.d)

Question #54 of 154

Where does the currency translation gain or loss appear in the financial statements under the temporal method and the current rate method?

Question #14 of 154

Question ID: 472485

Which of the following statements regarding the current rate method is the most accurate?

✗ **A) This method is not typically used when the subsidiary is relatively independent of the parent.**

✗ **B)** Income statements items are translated at the current exchange rate.

✓ **C)** Translation gains and losses are reported in equity.

Explanation

Under the current rate method, translation gains and losses are reported in equity in the CTA account. This method is typically used when the subsidiary is relatively independent of the parent. Revenues and expenses are translated at the average rate.

(Study Session 6, LOS 21.d)

Question #15 of 154

Question ID: 462385

The translation gain or loss from the activities of Grande, Inc., should be reported in:

- ✓ **A)** **the income statement.**
- ✗ **B)** the statement of cash flows.
- ✗ **C)** the statement of shareholder's equity.

Explanation

China's data should be remeasured under the temporal method into Hong Kong dollars, and then translated under the current rate method into U.S. dollars; and GIC Bahamas' data should be remeasured under the temporal method into U.S.

Under the temporal method, translation gains and losses are included in the income statement. (Study Session 6, LOS 21.e)

Question #16 of 154

Question ID: 462386

Revenues for 2001 translated into U.S. dollars amount to:

- ✗ **A)** **$6,000,000.**
- ✗ **B)** $7,800,000.
- ✓ **C)** $6,600,000.

Explanation

Under the temporal method, revenues are translated at the average rate during the reporting period.

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

60,000,000 × 0.11 = $6,600,000

(Study Session 6, LOS 21.e)

GIC Europe's data should be translated under the current rate method; GIC China's data should be remeasured under the temporal method into Hong Kong dollars, and then translated under the current rate method into U.S. dollars; and GIC

Question #17 of 154

Question ID: 462387

As a result of making the appropriate currency adjustments to the financial statements, Grande Inc.'s December 31, 2001 quick ratio will be:

- ✗ **A)** **higher.**
- ✗ **B)** lower.
- ✓ **C)** unchanged.

temporal method, as compared to the current rate method.

Explanation

- ✓ **B)** The receivables turnover ratio is identical under both the temporal method and the current rate method.
- ✗ **C)** In the case in which a firm uses first in, first out (FIFO) inventory valuation, if the local currency depreciates the cost of good sold under the temporal method is less than the cost of goods sold using the current rate method.

Since the functional currency is the reporting currency, the temporal method must be used. Since it is taking fewer dollars to buy a peso, the peso is depreciating.

The quick ratio is a liquidity ratio that does not include inventory. The quick ratio is calculated as [(cash + accounts receivable) / accounts payable]. Since monetary assets and liabilities are translated at the current rate, the quick ratio will be unchanged. (Study Session 6, LOS 21.e)

Explanation

The receivables turnover (sales / receivables) is unaffected because both methods translate sales at the average rate and accounts

Questions #18-23 of 154

Dell Air Lines has recently acquired Australian Puddle Jumpers, Inc., a small airline located in Sydney. The Australian dollar has been chosen by Dell as the functional currency for APJ. The Balance Sheet of APJ is given below as of Dec. 31, 2004 in Australian dollars.

Assets		*Liabilities and Equity*	
Cash	200	A/P	180
A/R	240	Common Stock	720
Maintenance Supplies	180		
Fixed Assets	280		
Total Assets	900	Total Liab & Equity	900

APJ's income statement for the year ending Dec. 31, 2005 is expressed in Australian dollars as:

Sales	3,500
Total Costs	2,900
Net Income	600

The Australian dollar has steadily depreciated against the U.S. dollar. At Dec. 31, 2004, the exchange rate was 2 Australian dollars = $1 but at Dec. 31, 2005, the exchange rate had deteriorated to 3 Australian dollars = $1.

The Dec. 31, 2005 Balance Sheet for APJ is given in Australian dollars as follows:

Assets		*Liabilities and Equity*	
Cash	441	A/P	210
A/R	330	Common Stock	720
Supplies	291	Retained Earnings	600
Fixed Assets	468		
Total Assets	1,530	Total Liab. & Equity	1,530

Question #18 of 154

Question ID: 462452

On APJ's 2005 income statement, the level of net income in U.S. dollars would be:

✗ **A) $300.**

✓ **B)** $240.

✗ **C)** $200.

issue and acquisition of fixed assets

Kasamatsu Industries Financial Data (12/31/02)			
	Yen (in thousands)	*Exchange Rate*	*U.S. Dollars (in thousands)*

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Since the Australian dollar is both the local and the functional currency, use the current rate method. The items in the income

Sales	700,000		
COGS	280,000		

statement are translated at the average exchange rate. The average rate is (2 + 3) / 2 = 2.5 Australian dollars = $1. (Study Session 6, LOS 21.e)

Question #19 of 154

Question ID: 462453

On APJ's 2005 balance sheet, the level of common stock (not including retained earnings) in U.S. dollars would be:

✗ **A) $288.**

✓ **B)** $360.

✗ **C)** $240.

Dividends	58,000		
2002 Retained Earnings	61,000		
Current Assets	50,000		
Fixed Assets	486,000		
Current Liabilities	46,000		
Long-Term Debt	254,000		

Explanation

Since the Australian dollar is the local and the functional currency, use the current rate method.

In the balance sheet, all accounts are translated at the current exchange rate, except for the common stock account, which is translated at the historical rate.

Common Stock: (720 / 2) = 360

(Study Session 6, LOS 21.e)

Question #20 of 154

Question ID: 462454

On APJ's 2005 balance sheet, the level of retained earnings in U.S. dollars would be:

✗ **A) $300.**

✓ **B)** $240.

✗ **C)** $200.

WB's net income (in thousands dollars)?

✗ **A) $821.**

✓ **B)** $850.

✗ **C)** $793.

Explanation

Since there is no mention of dividends being paid, the retained earnings will equal net income (RE = NI − Div). The items in the income statement are translated at the average exchange rate under SFAS 52. The average rate is (2 + 3) / 2 = 2.5 Australian dollars = $1.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Income Statement (in $)

Sales (3,500 / 2.5)	$1,400
Costs (2,900 / 2.5)	$1,160
Net Income	$240

Because Kasamatsu is a wholly owned subsidiary of WB, all of its net income will be included in WB's. Kasamatsu's local currency is also the functional currency, so the current rate method should be used to translate the financial statements into

(Study Session 6, LOS 21.e)

Question #21 of 154

Question ID: 462455

On APJ's 2005 balance sheet, the foreign currency translation adjustment in U.S. dollars would be:

✗ **A) −$220.**

✓ **B)** −$160.

✗ **C)** −$280.

Explanation

Since the Australian dollar is both the local and the functional currency, use the current rate method. ... of dividends. What is the U.S. dollar amount of this adjustment (in thousands)?

When using the current rate method, all assets and liabilities are translated at the current rate. Total assets = 1530/3 = 510 and accounts payable = 210/3 = 70. The common stock is translated at the historical rate on the date of purchase = 720/2 = 360. Beginning retained earnings = 0, so ending retained earnings = translated net income = 240. The cumulative translation adjustment is the plug figure that makes the balance sheet balance = 510 − 70 − 360 − 240 = −160. (Study Session 6, LOS 21.e)

- ✗ **A)** **$446.**
- ✓ **B)** $400.
- ✗ **C)** $414.

Question #22 of 154

Question ID: 462456

Which one of the following is a condition under which the temporal method should be used to account for foreign currency translations?

- ✗ **A)** **The Australian dollar is chosen as the functional currency.**
- ✗ **B)** The cumulative Australian inflation rate over the last three years would have to be less than 100%.
- ✓ **C)** APJ would have to be a mere operational extension of Dell's main operations.

- ✓ **A)** **$3,573.**
- ✗ **B)** $3,240.
- ✗ **C)** $2,938.

Explanation

The conditions necessary for implementation of the temporal method are:

1. APJ would have to be a mere operational extension of Dell's main operations. If the operations of the subsidiary are well integrated with the parent's then the parent's currency (in this case, the U.S. dollar) would be the functional currency.
2. The cumulative Australian inflation rate over the last 3 years would have to exceed 100%. (Hyperinflation)

(Study Session 6, LOS 21.d)

Explanation

Under the current rate method, all balance sheet accounts, with the exception of equity, are translated at the current rate. At the current rate of 150 under the current rate method, the amount is: (486,000 + 50,000) / 150 = $3,573. (Study Session 6, LOS 21.f)

Question #23 of 154

Question ID: 462457

Which one of the following statements correctly describes the effect on Dell's financial statements if the U.S. dollar had been chosen as the functional currency?

- ✗ **A)** **The current rate method would apply.**
- ✗ **B)** The translation adjustment would appear as a line item on Dell's balance sheet.
- ✓ **C)** The translation adjustment would appear as a line item on Dell's income statement.

Explanation

If the U.S. dollar had been chosen as the functional currency, then the provisions of the temporal method would apply. Under the temporal method, the translation adjustment would appear as a line item on Dell's income statement and not as an element of equity. Hence, earnings may become more volatile as a result. (Study Session 6, LOS 21.d)

Explanation

Under the current rate method, COGS is translated at the average rate in effect during the reporting period. Using the average exchange rate during 2002, COGS is calculated as 280,000 / 140 = $2,000. Using the average rate in effect during 2001 results in COGS of $2,333 (280,000 / 120), or $333 higher. (Study Session 6, LOS 21.f)

Question #24 of 154

Question ID: 462415

Which of the following measures is unaffected by the choice between translation under the current rate method and remeasurement under the temporal method?

- ✗ **A)** **Cost of goods sold.**
- ✗ **B)** Equity.

✓ **C)** Tax expense.

asset turnover ratio.

Explanation

✗ **B)** correct with respect to the quick ratio, but incorrect with respect to the total asset turnover ratio.

✓ **C)** incorrect with respect to the quick ratio, but correct with respect to the total asset turnover ratio.

Taxes are converted at the same rate (average rate) under both methods. Equity under the temporal method is a mixed rate whereas under the current rate method it is at the current rate. COGS under the temporal method is at the historical rate and under the current rate method it is at the average rate.

Explanation

Questions #25-30 of 154

Giant Company is a U.S. Company with a subsidiary, Grande, Inc., that operates in Mexico. Giant Company uses either the temporal or the current rate method of foreign currency translation for its subsidiaries.

- Grande, Inc., began operations January 1, 2012.
- Common Stock and Fixed Assets were acquired January 1, 2011.
- Inventory is accounted for under the last in, first out (LIFO) cost flow assumption, with a slow rate of turnover.
- The beginning *U.S. dollar* value of Giant's retained earnings was $2,600,000.
- The inventory in the January 1, 2012, Balance Sheet was acquired on January 1, 2012.

Exchange Rates were:	January 1, 2011	$0.14/peso
	January 1, 2012	$0.12/peso
	June 30, 2012	$0.11/peso (this is the 2012 average rate)
	December 31, 2012	$0.10/peso

	Grande, Inc.	
	Balance Sheet (in M Pesos)	
	Jan. 1, 2012	*Dec. 31, 2012*
Cash	5,000,000	20,000,000
Accounts Receivable (A/R)	20,000,000	35,000,000
Inventory	15,000,000	15,000,000
Fixed Assets (net)	90,000,000	60,000,000
Accounts Payable (A/P)	10,000,000	10,000,000
Long Term Debt	40,000,000	35,000,000
Common Stock	80,000,000	80,000,000
Retained Earnings		5,000,000
	2012 Income Statement (in Pesos)	
Sales	60,000,000	
Cost of Goods Sold (COGS)	(45,000,000)	
Depreciation	(10,000,000)	
Net Income	5,000,000	

Assume that Giant Company considers the Mexican peso to be both the local currency and the functional currency of Grande, Inc.

Question #25 of 154

Question ID: 462315

To reflect the results of Grande, Inc., in its financial statements, it would be *most* appropriate for Giant Company to use the:

✗ **A) temporal method.**

✗ **B)** current rate method followed by the temporal method.

✓ **C)** current rate method.

1,062,000 (= EUR 1,000,000 × 1.0620) for 2002 and USD 1,255,870 (= EUR 1,100,000 × 1.1417) for 2003.

Explanation

Growth measured from the parent's perspective suggests sales rose 18.25% [= (1,255,870 / 1,062,000) − 1], but this includes the growth rate in sales measured in the local currency *and* the rate of appreciation in the foreign currency, or (1.10 × 1.075) − 1 = 0.1825. The question only asks for the impact of the change in the value of the USD.

The current rate method is used when the Functional Currency is NOT the same as the Parent's Presentation (reporting) Currency. The temporal method is used when the Functional Currency = the Parent's Presentation Currency.

The current rate method is used when the local currency and functional currency are the same.

(LOS 21.d)

Question #65 of 154

Question ID: 462397

Question #26 of 154

Question ID: 462316

The Net Income of Grande, Inc., expressed in U.S. dollars for the year ended December 31, 2012, is *closest* to:

✗ **A) $500,000.**

✗ **B)** $250,000.

✓ **C)** $550,000.

Explanation

Explanation

Using the current rate method, the income statement is translated using the average rate for all income statement accounts:

Sales − COGS − Depreciation = Net Income: (60,000,000 × $0.11) − (45,000,000 × $0.11) − (10,000,000 × $0.11) = $550,000.

Under the current rate method, the average rate is applied to all income statement accounts. Hence, since the average rate is applied to both numerator and denominator of the equation and the ratio will not change.

(LOS 21.e)

Question #27 of 154

Question ID: 462317

What is the change in exposure for Grande, Inc., for the year ended December 31, 2012?

✗ **A) +$85,000,000 pesos.**

✓ **B)** +$5,000,000 pesos.

✗ **C)** +$35,000,000 pesos.

Region	(USD)*	(USD)*	Tax rate
Latin America	5%	4%	25%
North America	3%	3%	35%
Europe	2%	−1%	45%
Asia pacific	4%	6%	20%

*Growth rate indicates expected growth rate over the next five years.

Sopgate's effective tax rate is *most likely* expected to:

Explanation

Exposure under the current rate method is simply equal to equity.

Beginning exposure = 80,000,000 pesos

Ending exposure = 85,000,000 pesos

Change in exposure = 85,000,000 pesos − 80,000,000 pesos = +5,000,000 pesos

(LOS 21.e)

Question #28 of 154

Question ID: 462318

The translation gain or loss from the activities of Grande, Inc., should be reported in the:

✗ **A) income statement.**

✗ **B)** statement of cash flows.

✓ **C)** equity accounts.

effective tax rate can be expected to decrease.

Explanation

Under the current rate method, translation gains or losses are accumulated on the balance sheet in the equity section.

(LOS 21.f)

Question #67 of 154

Question ID: 462365

Question #29 of 154

Question ID: 462319

Compared to the current ratio before translation, the current ratio after translation is *most likely* to be:

✗ **A)** **higher.**

✓ **B)** the same.

✗ **C)** lower.

Explanation

Translation of the local currency means the current rate method is applied. The current ratio is current assets divided by current liabilities. The current assets and the current liabilities are both translated at the current rate. This leads to the ratio remaining the same in terms of both the local currency and the presentation currency.

Question #68 of 154

Question ID: 462366

Which of the following statements regarding foreign currency translation are *least* accurate? Under the:

(LOS 21.f)

Question #30 of 154

Question ID: 462320

The cumulative translation adjustment (CTA) for 2012 is *closest* to:

✓ **A)** **a loss of $3,250,000.**

✗ **B)** a loss of $550,000.

✗ **C)** a gain of $1,900,000.

Explanation

The Mexican peso is depreciating and there is a net asset; this will result in a CTA loss.

Question #69 of 154

Question ID: 462393

Which of the following ratios is affected by translation under the current rate method?

✗ **A)** **Debt/Assets ratio.**

✗ **B)** Net profit margin.

✓ **C)** Fixed asset turnover ratio.

Explanation

Recall that all pure income statements and balance sheet ratios are unaffected by translation under the current rate method. The fixed asset turnover ratio is not a pure ratio; it consists of an income statement measure (sales, translated at the average rate) and a balance sheet measure (fixed assets, translated at the current rate).

Balance Sheet	2012 (MXN)	Rate (USD/MXN)	2013 (USD)
Cash	20,000,000	0.1000	$2,000,000
A/R	35,000,000	0.1000	$3,500,000
Inventory	15,000,000	0.1000	$1,500,000
Current assets	70,000,000		$7,000,000
Net Fixed Assets	60,000,000	0.1000	$6,000,000
Total Assets	130,000,000		$13,000,000
Accounts payable (A/P)	10,000,000	0.1000	$1,000,000
Long-term debt	35,000,000	0.1000	3,500,000
Common Stock	80,000,000	0.1400	$11,200,000
Retained Earnings	5,000,000	from I/S	$550,000
CTA			($3,250,000)

Question #70 of 154

Question ID: 462301

Which of the following statements regarding the functional currency is *least* accurate? The functional currency:

✗ **A) is the currency of the primary economic environment in which the foreign subsidiary generates and expends cash.**

✓ B) is remeasured into the reporting currency under the temporal method.

✗ C) is determined by management.

Explanation

(LOS 21.d)

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Question #31 of 154

Question ID: 462352

Which of the following situations does NOT require the use of the temporal method? The:

✓ **A) local currency is the functional currency.**

✗ B) functional currency is some currency other that the local currency or the U.S. dollar.

✗ C) foreign subsidiary is operating in a highly inflationary economy.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

The temporal method is not required in the situation when the local currency is the functional currency.

Question #32 of 154

Question ID: 462467

Organic growth in sales is *most* accurately defined as growth in sales excluding the effects of:

✓ **A) acquisitions/divestitures and currency value fluctuations.**

✗ B) currency value fluctuations.

✗ C) acquisitions/divestitures only.

Explanation

Organic growth in sales is defined as growth in sales excluding the effects of acquisitions/divestitures and currency effects.

Question #33 of 154

Question ID: 462351

Which of the following statements is *least* accurate regarding accounting for foreign currency translations? The:

✓ **A) current rate method applies the current exchange rate to all balance sheet accounts.**

✗ B) current rate method applies the average exchange rate to all income statement accounts.

Total equities	85,000,000		$8,500,000
Total Liabilities and equity	130,000,000		$13,000,000

Income Statement	2012		
Sales	60,000,000	0.1100	$6,600,000
Cost of goods sold	−45,000,000	0.1100	($4,950,000)
Depreciation	−10,000,000	0.1100	($1,100,000)
Net income	5,000,000		$550,000

owned foreign subsidiaries, Kasamatsu Industries, is based in Japan. Kasamatsu manufactures a hugely successful line of trading cards, toys, and related products. All of Kasamatsu's operations and sales take place in Japan, and the corresponding transactions are denominated in Japanese yen. Additionally, Kasamatsu's books and records are all maintained in yen. WB reports its earnings in U.S. dollars. The history of the exchange rate between the dollar and the yen over the last two years is presented in the following table. Figures are presented in yen/$.

Yen/Dollar Exchange Rate	
December 31, 2013	150

acquisition of fixed assets.

Shelby Lagrowth is an analyst with the asset management firm of New York, and is the chief analyst covering WB. She believes that the enormous success of the trading cards has contributed greatly to WB's bottom line. However, Jameson believes that this effect may be misstated in the company's financial statements because of the recent volatility in exchange rates. Many analysts at

✗ **C)** temporal method uses the historical exchange rate to translate non-monetary assets and liabilities into the currency of the country of the parent company.

Explanation

Sales 700,000

The current rate method applies the current exchange rate to all balance sheet accounts except for common stock, *which is translated at a historical rate*.

Expenses

~~Cost of Goods Sold (COGS) 280,000~~

Depreciation 126,000

Question #34 of 154

Question ID: 462413

Which example *least accurately* describes pure balance sheet and income statement ratios?

✗ **A)** **The current ratio is a pure balance sheet ratio.**

✗ **B)** When multiplying both the numerator and denominator by the current exchange rate, the current rate is cancelled.

✓ **C)** All pure balance sheet ratios are affected by the all-current translation method.

Dividends

Explanation

Retained Earnings: December 31, 2013 * 311,000

All pure balance sheet ratios are unaffected by the all-current translation method.

* Retained earnings on 12/31/2013 were US $2million

Questions #35-36 of 154

Wasson Brothers (WB) is a large U.S. based conglomerate with many subsidiaries in both the U.S. and abroad. One of WB's wholly-owned foreign subsidiaries, Kasamatsu Industries, is based in Japan and manufactures a hugely successful line of trading cards, toys, and other related products. All of Kasamatsu's operations and sales take place in Japan, and the corresponding transactions are denominated in Japanese yen. Additionally, Kasamatsu's books and records are all maintained in yen. WB reports its earnings in U.S. dollars. The history of the exchange rate between the dollar and the yen over the last two years is presented in the following table. Figures are presented in Yen/dollars.

Yen / Dollar Exchange Rate

December 31, 2005	150
December 31, 2004	130
2005 Average	140
2004 Average	120
Exchange rate on date that 2005 dividends were paid to Wasson Brothers	145
Exchange rate on date of stock issue and acquisition of fixed assets	100

Ashley Jameson is an analyst with Henderson-Wells, an investment banking firm in New York, and is the chief analyst covering

WB. She believes that the enormous success of the trading cards has contributed greatly to WB's bottom line. However, she believes that this effect may be misstated in the company's financial statements because of the recent volatility in exchange rates. Many analysts at other major investment banking firms have been raising their ratings on WB because of the recent earnings growth. Jameson, however, wants to be absolutely certain that these results are accurate and fully attributable to Kasamatsu's hot new product and not a result of an exchange rate fluctuation. The following are the financial statements of Kasamatsu, stated in thousands of yen.

Financial Statements for Year Ending December 31, 2005

(in thousands of yen)

Statement of Income and Retained Earnings

Sales	700,000
Expenses	
Cost of goods sold (COGS)	280,000
Depreciation	126,000
SG&A	77,000
Total Expenses	483,000
Earnings before taxes (EBT)	217,000
Income Tax Expense	98,000
Net Income	119,000
Retained Earnings: December 31, 2004	250,000
	369,000
Dividends	58,000
Retained Earnings: December 31, 2005*	311,000

*Retained earnings on 12/31/2005 were US $2 million

Balance Sheet

Assets	
Cash and receivables	60,000
Inventory	180,000
Land	200,000
Fixed assets	346,000
Total assets	786,000
Liabilities and stockholder's equity	
Liabilities	300,000
Capital stock	175,000
Retained earnings	311,000
Total liabilities and stockholder's	

equity	786,000

Question #35 of 154

Question ID: 472483

Before Jameson can perform any financial statement analysis she needs to determine which method WB uses to translate Kasamatsu's earnings into U.S. dollars (USD). Which of the following is the *most* appropriate method to use?

✗ **A) First the temporal method, followed by the current rate method.**

✗ **B)** The temporal method.

✓ **C)** The current rate method.

$\frac{483{,}000¥}{140\ ¥/\$} = 3{,}450$

The other answers use inappropriate exchange rates.

(LOS 21.d)

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Under U.S. GAAP the current method must be used to translate the yen financial statements into USD, the reporting currency. Had Kasamatsu been operating in a highly inflationary environment or had the local and functional currency not been the same, then WB would be required to use the temporal method.

Question #75 of 154

Question ID: 462347

Question #36 of 154

Question ID: 462370

Jameson must also determine how the fluctuation in the yen vs. the dollar has affected Kasamatsu's earnings in the reporting currency. Which of the following *best* describes the effect of changes in the yen/dollar rate has had on earnings in the reporting currency? Earnings have:

✓ **A) decreased because the yen is depreciating versus the USD.**

✗ **B)** increased because the yen is appreciating versus the USD.

✗ **C)** increased because the yen is depreciating versus the USD.

Explanation

The current rate method is used when the functional currency is NOT the same as parent's presentation (reporting) currency. The temporal method is used when Functional Currency = Parent's Presentation Currency.

Examination of the history of the exchange rate shows that both the year-end and average exchange rates are lower in 2005 [illegible] [illegible] [illegible] income.

(LOS 21.d)

Question #37 of 154

Question ID: 462405

The Herlitzka Company, a U.S. multinational firm, has a 100% stake in a Swiss subsidiary. The Swiss franc (SF) has been determined to be the functional currency. All the common stock of the subsidiary was issued at the beginning of the year and the subsidiary uses the FIFO inventory cost-flow assumption. In addition, the value of the SF is as follows:

Beginning of year	$0.5902
Average throughout the year	$0.6002
End of year	$0.6150

The SF-based balance sheet and income statement data for the Swiss subsidiary are as follows:

Accounts receivable	= 3,000
Inventory	= 4,000
Fixed assets	= 12,000
Accounts payable	= 2,000
Long-term debt	= 5,000
Common stock	= 10,000
Retained earnings	= 2,000
Net income	= 2,000

The translated value of common stock and long-term debt respectively are:

- ✗ **A) $5,902 and $3,001.**
- ✗ **B)** $6,150 and $3,075.
- ✓ **C)** $5,902 and $3,075.

presentation currency.

Explanation

✗ C) dramatically appreciate and the local currency will be rapidly appreciating against the presentation currency.

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency.

The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Explanation

Since the SF is the functional currency, use the current rate method. Common stock is translated at the historical rate which is the rate that applied when the transaction was made or $0.5902 and long-term debt is translated at the current rate of $0.615. 10,000 × 0.5902 = $5,902 for common stock and 5000 × 0.6150 = $3,075 for long term debt.

Purchasing power *and* Deadoa currency will depreciate.

Question #38 of 154

Question ID: 462402

Which of the following subsidiary ratios will be affected by the translation adjustment under the current rate method?

- ✗ **A) Net profit margin.**
- ✓ **B)** Return on equity.
- ✗ **C)** Gross margin.

✗ C) Fixed assets are realtively overstated under the temporal method compared to the local currency if the local currency has appreciated.

Explanation

The translation adjustment will affect the book value of equity and therefore the return on equity ratio. The other ratios are pure ratios (both component of the ratio come from the income statement) and are not affected by translation.

Explanation

Fixed assets are relatively understated under the temporal method if the local currency appreciates as they are translated at

---

Question #39 of 154

Question ID: 462312

A Canadian firm owns a foreign subsidiary in the U.S. In 2002, sales were USD1,000,000 and the USD/CAD exchange rate was 0.6329. In 2003, sales were also USD1,000,000 but the exchange rate was 0.7484. What is the impact of the change in the value of the CAD on the parent company's translated sales? Sales will:

- ✗ **A) increase by 18%.**

✗ **B)** decrease by 18%.

✓ **C)** decline by 15%.

✗ **C)** Current ratio.

Explanation

While sales were flat at USD 1,000,000 in local currency terms, after translation the parent firm would report sales of CAD 1,336,184 for 2003 (= USD 1,000,000 / 0.7484) versus sales of CAD 1,580,028 for 2002 (= USD 1,000,000 / 0.6329). The 15% sales decline reported by the Canadian firm (CAD 1,336,184 versus CAD 1,580,028) is a flow effect. Even though there was no sales growth in the subsidiary, the parent firm still shows a 15% decrease in revenues from the subsidiary due solely to exchange rate effects. Note that because the subsidiary sales are constant the total exchange rate effect can be measured as (0.6329 / 0.7484) − 1 = −0.15.

Explanation

All of the components of the quick ratio (cash and cash equivalents, accounts receivable, and accounts payable) are converted at the same rate under both methods so the ratio is unaffected by the method. The current ratio is the same as the quick ratio except it also contains inventory which is translated at the historical rate with the temporal method and at the current rate with the current rate method. Accounts payable turnover is purchases/accounts payable. Purchases is an inventory item (like COGS) that may not use the same rate under the temporal method and the current rate method.

Question #40 of 154

Question ID: 462400

The U.S. dollar has been depreciating relative to the local currency over the past year. The use of the current rate method to translate a foreign subsidiary's financial statements to U.S. dollars will *most likely* have which of the following effects on return on equity (ROE) relative to what the ratio would have been without the effects of translation?

✓ **A) ROE will most likely decline.**

✗ **B)** ROE will most likely rise.

✗ **C)** The impact of the depreciation of the US dollar on ROE is indeterminate.

Explanation

ROE = Net income / Equity. Under the current rate method, the equity accounts as a whole are translated at the current rate whereas net income is translated at the average rate. Since the dollar is depreciating, each foreign currency unit is buying more dollars in the denominator relative to the numerator of the equation. Hence, the denominator is increasing and the entire ratio falls.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Since the functional currency is the local currency, use the current rate method. The net income is translated at the average

Question #41 of 154

Question ID: 462389

The Herlitzka Company, a U.S. multinational firm, has a 100 percent stake in a Swiss subsidiary. The U.S. dollar (USD) has been determined to be the functional currency. All the common stock of the subsidiary was issued at the beginning of the year and the subsidiary uses the weighted-average inventory cost-flow assumption. In addition, the value of the SF is as follows:

Beginning of year	$0.5902
Average throughout the year	$0.6002
End of year	$0.6150

The SF-based balance sheet and income statement data for the Swiss subsidiary are as follows:

Accounts receivable	= 3,000
Inventory	= 4,000
Fixed assets	= 12,000
Accounts payable	= 2,000
Long-term debt	= 5,000
Common stock	= 10,000

Retained earnings	= 2,000
Net income	= 2,000

The remeasured value of accounts receivable and inventory respectively are *closest* to:

what the ratio would have been without the effects of translation?

✗ A) **The ratio will be lower.**

✗ B) The ratio will be higher.

✓ C) The ratio will be the same.

Explanation

Under the current rate method, both LTD and equity are translated at the current rate of exchange. Hence, since the same rate is applied in both the numerator and denominator, the ratio will not change.

Note: When equity is broken out into separate accounts, common stock is taken at the historical rate. When taken as a whole, equity should be translated at the current rate. In this case we are not given any information on the common stock amount, so we translate equity at the current rate.

Question #83 of 154

Question ID: 462390

Hann Company is a U.S. multinational firm with operations in several foreign countries. Hann has a 100 percent stake in a French subsidiary. The foreign subsidiary's local currency has appreciated against the U.S. dollar over the latest financial statement reporting period. In addition, the French firm accounts for inventories using the FIFO inventory cost-flow assumption. The net profit margin as computed under the current rate method would *most likely* be:

✗ A) **lower than the same ratio computed under the temporal method.**

✓ B) either higher or lower than the same ratio computed under the temporal method.

✗ C) higher than the same ratio computed under the temporal method.

Explanation

The foreign currency gain or loss appears on the income statement under the temporal method. Hence, to make any determinations regarding the movements of this ratio, we need more information regarding the net monetary asset or liability position as of both the beginning and ending balance sheet date.

Question #84 of 154

Question ID: 462355

Which of the following statements is *least* accurate regarding the use of the temporal method for foreign exchange accounting?

✓ A) **Under the temporal method, the foreign exchange gain or loss is placed on the balance sheet in the equity section.**

✗ B) All nonmonetary assets and liabilities are translated at the historical rate of exchange.

✗ C) All monetary assets are translated at the current rate of exchange.

Explanation

Under the temporal method, the foreign exchange gain or loss is placed on the *income statement*.

Question #85 of 154

Question ID: 462403

Which of the following statements concerning the translation of a subsidiary's financial statement and the subsidiary's ratios is *least* accurate?

✗ **A) The subsidiary's ratios in the local currency will differ from ratios calculated after translation.**

✗ **B)** The statement of cash flows is not affected by the choice of translation.

✓ **C)** Ratios calculated under the current rate method will not differ from those calculated under the temporal method.

Explanation

Ratios calculated under the current rate method will differ from those calculated under the temporal method.

Question #86 of 154

Question ID: 462311

A German company (reporting currency = Euro) owns a foreign subsidiary in the U.S. If the results below are reported in local currency (USD), after translation what is the effect of the change in the exchange rate on revenues? Round to the nearest dollar and/or percent.

Year	*Sales*	*$ per 1 Euro avg. Exchange Rate*
2001	$10,000	0.9
2002	$10,000	0.8

✓ **A) The company shows a 12.5% growth in revenues in 2002.**

✗ **B)** There is no change is revenue growth between 2001 and 2002.

✗ **C)** The company shows a 0.1% decline in revenues in 2002.

Explanation

While sales were flat in terms of local currency, after translation the reported revenue increased 12.5%. 10,000/0.9 = 11,111; 10,000/0.8 = 12,500; 12,500/11,111 = 12.5% increase due to exchange rate effects.

Question #87 of 154

Question ID: 462363

Which of the following statements regarding the functional currency under US GAAP is *least* accurate?

✗ **A)** **If a firm operates in a country or environment which is subject to cumulative inflation of 100% or more over a three year period, that firm will use the parent's currency as the functional currency.**

✗ **B)** Self-contained, independent subsidiaries whose operations are primarily located in the local market will use the local currency as the functional currency.

✓ **C)** The functional currency is defined as the primary currency of the economic environment in which the parent firm operates.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

The functional currency is defined as the primary currency of the economic environment in which the *foreign subsidiary* operates.

Question #88 of 154

Question ID: 462380

Gortal Inc, a U.S.company has a wholly owned subsidiary, Fortina GmBh, based in Germany. The U.S. dollar has been appreciating relative to the Euro over the past year. The use of the temporal method to translate a foreign subsidiary's financial statements to U.S. dollars will *most likely* have which of the following effects on the fixed-asset turnover ratio (S/FA) relative to what the ratio would have been without the effects of translation assuming no new fixed assets were purchased throughout the year?

✓ **A)** **The ratio will be lower.**

✗ **B)** The ratio will be higher.

✗ **C)** There will be no effect on the ratio.

Explanation

Since the dollar has appreciated, the local currency has depreciated, so each foreign currency unit bought more dollars in the past relative to the present. Fixed assets are remeasured at the historical rate and sales are remeasured at the average rate under the temporal method. Since the historical rate is buying more dollars relative to the average rate, the denominator is staying the same whereas the numerator is getting smaller. Thus, the ratio is lower.

Questions #89-94 of 154

Assume that Scud Co. is a Swiss subsidiary of the U.S. firm Patriot, Inc. On December 31, 2007 the $/SF exchange rate was 0.77. (Each Swiss Franc buys 77 cents.) Assume that this is the historical rate, except as noted below. One year later the Swiss Franc had appreciated to 0.85 $/SF. Scud Co. pays no dividends. The average exchange rate for the year was 0.80 $/SF. Scud pays no taxes. Assume that inventory is accounted for using the LIFO inventory assumption, was bought and sold evenly throughout the year, and that COGS is translated at the average rate for the year.

> *Scud Co. Int'l*
>
> *Balance Sheet (in SF thousands)*
>
> *Dec. 31, 2007* *Dec. 31, 2008*

Cash & A/R	400	600
Inventory	500	500
Net Fixed Assets	700	600
Total Assets	*1,600*	*1,700*
A/P	100	200
Long-term debt	200	100
Common Stock	1,300	1,300
Retained Earnings	0	100
Total Liabilities	*1,600*	*1,700*

Income Statement (in SF thousands)

December 31, 2008

	In SF
Sales	7,000
COGS	(6,800)
Depreciation	(100)
Remeasurement Gain/Loss	--
Net Income	*100*

Assume that the functional currency is the U.S. dollar when answering the following questions.

Question #89 of 154

Question ID: 462431

The level of cash on the 2008 remeasured balance sheet would be:

✗ A) **$480.**

✓ B) $510.

✗ C) $462.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Since the U.S. dollar is the functional currency and the reporting currency, the temporal method should be used to remeasure the Swiss Franc into U.S. dollars. With the temporal method monetary assets like cash and monetary liabilities are remeasured at the current exchange rate. 600SF × 0.85$/SF = $510. (Study Session 6, LOS 21.e)

Question #90 of 154

Question ID: 462432

The level of net fixed assets on the remeasured 2008 balance sheet would be:

✓ A) **$462.**

✗ B) $480.

✗ C) $510.

Explanation

Net fixed assets are considered non-monetary assets. For non-monetary assets, the temporal method uses the historical rate: 600SF ×

0.77$/SF = $462. (Study Session 6, LOS 21.e)

Question #91 of 154

Question ID: 462433

Which of the following ratios may be larger in the presentation currency versus the local currency when translated under the current rate method?

- ✗ A) **Net profit margin.**
- ✓ B) Return on assets.
- ✗ C) Current ratio.

Explanation

All pure income statement and balance sheet ratios are unaffected by the application of the current rate method. What we mean by "pure" is that the components of the ratio all come from the balance sheet, or the components of the ratio all come from the income statement. Return on assets is a "mixed ratio" because assets come from the balance sheet and are translated at the current rate and net income is translated at the average rate. Unless the exchange rate doesn't change during the year, the two inputs will be translated at different rates, and the local currency value of the ratio will change when translated into the reporting currency. The other ratios will always be the same using the current rate method. (Study Session 6, LOS 21.e)

Question #92 of 154

Question ID: 462434

The level of retained earnings on the remeasured 2008 balance sheet would be:

- ✓ A) **$101.**
- ✗ B) $85.
- ✗ C) $305.

Explanation

To get this value, we need to finish remeasuring our balance sheet at the appropriate rates. The retained earnings figure will be what makes the balance sheet balance.

Scud Co. Int'l

Balance Sheet (in SF thousands)

	Dec. 31, 2008	Remeasured $
Cash & A/R	600 × 0.85 =	510
Inventory	500 × 0.77 =	385
Net Fixed Assets	600 × 0.77 =	462
Total Assets	1,700	1,357
A/P	200 × 0.85 =	170
Long-term debt	100 × 0.85 =	85
Common Stock	1,300 × 0.77 =	1001
Retained Earnings	100	101
Total Liabilities and Owner's Equity	1,700	1,357

(Study Session 6, LOS 21.e)

Question #93 of 154

Question ID: 462435

The level of sales on the remeasured income statement would be:

- ✗ A) **$5,390.**
- ✓ B) $5,600.
- ✗ C) $5,950.

Explanation

Revenues and SG&A use the average exchange rate with both the temporal and current rate methods.

7000SF × 0.80$/SF = $5600

(Study Session 6, LOS 21.e)

Question #94 of 154

Question ID: 462436

The translation gain or loss on the income statement would be:

- ✗ A) **$25.**
- ✗ B) $0.
- ✓ C) $18.

Explanation

We need to complete our remeasurement of the income statement. Since beginning retained earnings for the year were zero, we know that net income on the remeasured income must be equal to ending retained earnings. The remeasurement gain or loss is the plug figure that causes this to be the case.

Income Statement (in SF thousands)

December 31, 2008

Sales	7,000 × 0.80 =	$5,600
COGS	(6,800) × 0.80 =	$5,440
Depreciation	100 × 0.77 =	= $77
Income before remeasurement gain/loss		= $83
Remeasurement gain = Plug		= $18
Net Income		$101

(Study Session 6, LOS 21.e)

Question #95 of 154

Question ID: 462350

Which of the following general statements is *most* accurate with respect to the current rate method? Revenues:

- ✗ A) **and operating expenses are translated at the current rate.**
- ✗ B) are translated at the average rate while operating expenses are translated at the current rate.

✓ **C)** and operating expenses are translated at the average rate.

Explanation

As a general rule for the current rate method, all revenues and operating expenses are translated using the average rate.

Question #96 of 154

Question ID: 462394

Hann Company is a U.S. multinational firm with operations in several foreign countries. Hann has a 100% stake in a French subsidiary. The foreign subsidiary's local currency has appreciated against the U.S. dollar over the latest financial statement reporting period. In addition, the French firm accounts for inventories using the first in, first out (FIFO) inventory cost-flow assumption. The gross profit margin as computed under the current rate method would *most likely* be:

✗ **A) higher than the gross profit margin as computed under the temporal method.**

✗ **B)** equal to the gross profit margin as computed under the temporal method.

✓ **C)** lower than the gross profit margin as computed under the temporal method.

Explanation

The average rate is used to convert sales under both the temporal method and the current rate method. Hence, the only difference between the two computations is on cost of goods sold (COGS). Since the firm uses FIFO, older materials are flowing into COGS and an older exchange rate applies. Since in the past the foreign currency bought fewer dollars, the gross profit under the temporal method will be higher than that of the current rate method.It may help to 'think' that with the current rate method, you use the average rate for COGS, which makes COGS higher because the currency has appreciated.

Question #97 of 154

Question ID: 462362

Dave Iverson, CFA, is analyzing the recently released financial statement of Global Corp., a large multinational manufacturing company with production facilities across Europe and Southeast Asia. The company's choice of functional currency is not disclosed, but Iverson does notice that Global Corp. does not have any cumulative translation adjustments (CTA) on its balance sheet. Which of the following statements is *most* accurate based upon Iverson's observation?

✗ **A) The temporal method of foreign currency translation is used for at least some of its subsidiaries.**

✗ **B)** The current rate method of foreign currency translation is used exclusively.

✓ **C)** The temporal method of foreign currency translation is used exclusively.

Explanation

The choice of functional currency is the determining factor as to which method of foreign currency translation is utilized. If no CTA appears on the balance sheet, then the parent currency must be the functional currency for all of the company's subsidiaries and only the temporal method is used.

Questions #98-103 of 154

A U.S. company has a subsidiary based in Malaysia, which has the following income statement for 2006 and balance sheets for 2005 and

2006 (in million Ringgit).

Sales	1,000
Cost of goods sold	600
Depreciation	80
Operating expenses	120
Earnings before taxes	200
Taxes	60
Net income	140
Dividends	20

	2005	*2006*
Cash	50	60
Accounts receivables	100	110
Inventories	100	110
Other current assets	100	110
Gross PP&E	700	800
Less accumulated depreciation	70	150
Net PP&E	630	650
Other fixed assets	20	40
Total assets	1,000	1,080
Account payable	70	80
Current portion of LTD	100	100
Notes payable	100	150
Other current liabilities	30	30
Long-term debt	300	200
Common stock	100	100
Paid in capital	50	50
Retained earnings	250	370

The value of the Ringgit at various times over the past two years is as follows:

January 1, 2005	$0.37
April 1, 2005	$0.38

December 31, 2005	$0.40
June 30, 2006	$0.47
December 31, 2006	$0.50
Average for 2005	$0.39
Average for 2006	$0.45

The common stock and long-term debt were originally issued in January of 2005. The fixed assets and first inventory purchases were made in April of 2005. Additional fixed asset purchases were made in June 2006. Inventory is measured using the FIFO method. It can be assumed that all of the ending inventory was acquired in June when the last major purchase was made. The operations of the subsidiary are independent from the operations of the U.S. parent. Inflation over the past three years has averaged 15% per year.

Question #98 of 154

Question ID: 462424

The amount of 2006 cost of goods sold in USD is:
(Note: if needed, use $0.40 as the rate to convert 2005 ending inventory)

- ✗ **A)** **$300,000,000.**
- ✓ **B)** $270,000,000.
- ✗ **C)** $262,800,000.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Because the operations are independent from the parent, the current rate method will be used. Cost of goods sold should be accounted for at the average rate for the past year. The amount of cost of goods sold is 0.45 × 600,000,000 = $270,000,000. (Study Session 6, LOS 21.e)

Question #99 of 154

Question ID: 462425

The value of December 31, 2006, gross property, plant, and equipment reported in USD is:

- ✓ **A)** **$400,000,000.**
- ✗ **B)** $304,000,000.
- ✗ **C)** $313,000,000.

Explanation

Because the operations are independent from the parent, the current rate method will be used. Fixed assets should be accounted for at the current rate. The value is 0.5 × 800,000,000 = $400,000,000. (Study Session 6, LOS 21.e)

Question #100 of 154

Question ID: 462426

The amount of 2006 depreciation expense in USD is:

- ✗ **A)** **$30,400,000.**

✗ **B)** $40,000,000.

✓ **C)** $36,000,000.

Explanation

Because the operations are independent from the parent, the current rate method will be used. Depreciation should be accounted for at the average rate for the past year. The amount of depreciation is 0.45 × 80,000,000 = $36,000,000. (Study Session 6, LOS 21.e)

Question #101 of 154

Question ID: 462427

The value of December 31, 2006, inventory reported in USD is:

✓ **A)** **$55,000,000.**

✗ **B)** $49,500,000.

✗ **C)** $51,700,000.

Explanation

Because the operations are independent from the parent, the current rate method will be used. Inventory should be accounted for at the current rate. The value is 0.50 × 110,000,000 = $55,000,000. (Study Session 6, LOS 21.e)

Question #102 of 154

Question ID: 462428

The value of all financing debt (notes payable, current portion of long-term debt, and long-term debt) on December 31, 2006, reported in USD is:

✗ **A)** **$202,500,000.**

✓ **B)** $225,000,000.

✗ **C)** $171,000,000.

Explanation

Because the operations are independent from the parent, the current rate method will be used. All debt is considered a monetary liability and should be accounted for at the current rate. The value is 0.50 × 450,000,000 = $225,000,000. (Study Session 6, LOS 21.e)

Question #103 of 154

Question ID: 462429

The combined value of the common stock and paid in capital on December 31, 2006, reported in USD is:

✗ **A)** **$75,000,000.**

✓ **B)** $55,500,000.

✗ **C)** $63,000,000.

Explanation

Because the operations are independent from the parent, the current rate method will be used. Common stock should be accounted for at the historical rate-the rate in effect when it was issued. The value is 0.37 × 150,000,000 = $55,500,000. (Study Session 6, LOS 21.e)

Questions #104-109 of 154

Della Air Lines has recently acquired Australian Puddle Jumpers, Inc. (APJ), a small airline located in Sydney. The Australian dollar has been chosen by Della as the functional currency for APJ. The balance sheet of APJ is given below as of Dec. 31, 2011 in U.S. dollars.

Assets		*Liabilities and Equity*	
Cash	$100	Accounts Payable (A/P)	$90
Accounts Receivable (A/R)	120	Common Stock	360
Maintenance Supplies	90		
Fixed Assets	140		
Total Assets	$450	Total Liabilities & Equity	$450

APJ's income statement for the year ending Dec. 31, 2012 is expressed in Australian dollars as:

Sales	3,500
Total Costs	2,900
Net Income	600

The Australian dollar has steadily depreciated against the U.S. dollar. At Dec. 31, 2011, the exchange rate was 2.5 Australian dollars = $1 but at Dec. 31, 2012, the exchange rate had deteriorated to 3 Australian dollars = $1.

The Dec. 31, 2012 Balance Sheet for APJ is given in Australian dollars as follows:

Assets		*Liabilities and Equity*	
Cash	441	A/P	210
A/R	330	Common Stock	720
Supplies	291	Retained Earnings	600
Fixed Assets	468		
Total Assets	1,530	Total Liabilities & Equity	1,530

Question #104 of 154

Question ID: 462329

On APJ's 2012 income statement, the level of sales in U.S. dollars would be *closest* to:

✓ **A) $1,272.**

✗ **B)** $1,377.

✗ **C)** $1,985.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Since the Australian dollar is the functional currency, use the current rate method. The items in the income statement are translated at the *average* exchange rate. The average rate is (2.5 + 3) / 2 = 2.75 Australian dollars per = US$.

Income Statement (in $)	
Sales (3,500 / 2.75)	$1,272
Costs (2,900 / 2.75)	$1,055
Net Income	$217

(LOS 21.d)

Question #105 of 154

Question ID: 462330

On APJ's 2012 income statement, the level of net income in U.S. dollars would be *closest* to:

✓ **A)** **$217.**

✗ **B)** $242.

✗ **C)** $229.

Explanation

Since we are using the current rate method, the items in the income statement are translated at the *average* exchange rate. The average rate is (2.5 + 3) / 2 = 2.75 Australian dollars per $1.

> *Income Statement (in $)*
>
> | | |
> |---|---|
> | Sales (3,500 / 2.75) | $1,272 |
> | Costs (2,900 / 2.75) | $1,055 |
> | **Net Income** | $217 |

(LOS 21.d)

Question #106 of 154

Question ID: 462331

On APJ's 2012 balance sheet, the level of accounts receivable is U.S. dollars would be *closest* to:

✗ **A)** **$132.**

✗ **B)** $330.

✓ **C)** $110.

Explanation

Since we are using the current rate method, all balance sheet accounts are translated at the current exchange rate, except for the common stock account, which is translated at the historical rate.

> A/R: (330 / 3) = 110

(LOS 21.d)

Question #107 of 154

Question ID: 462332

For APJ, the conversion to US$ is *most likely* to result in:

✓ **A)** **cumulative translation adjustment loss**

✗ **B)** cumulative translation adjustment gain.

✗ **C)** remeasurement gain.

Explanation

APJ shows a net asset:

Total assets A$1,530 / (3.00 A$/US$) = US$510

Total liabilities A$210 / (3.00 A$/US$) = US$70

Net asset = US$440

Because the functional currency is the local currency, the current rate method is used. When we have a net asset balance sheet exposure, a weakening foreign currency will result in a negative translation adjustment. AJP's net asset position will result in a cumulative transaction adjustment loss as the foreign currency, the A$, is depreciating.

Exposure	Foreign Currency	
Current rate method:	Appreciating	Depreciating
Net assets	Gain	Loss
Net liabilities	Loss	Gain

(LOS 21.d)

Question #108 of 154

Question ID: 462333

If the functional currency is the reporting currency, the exposure and the foreign currency movements are *most likely* to result in a:

✗ **A) remeasurement gain.**

✗ **B)** cumulative translation adjustment loss.

✓ **C)** remeasurement loss.

Explanation

APJ has a net monetary asset exposure:

Total monetary assets: Cash + A/R and Maintenance supplies A$1,062 / (3.00 A$/US$) = US$354

Total monetary liabilities: A$210 / (3.00 A$/US$) = US$70

Net monetary asset = US$284

Because the functional currency is the reporting currency, the temporal method is used and this means there is remeasurement - a loss as the foreign currency, the A$, is depreciating.

Exposure	Foreign Currency	
Temporal method:	Appreciating	Depreciating
Net monetary assets	Gain	Loss
Net monetary liabilities	Loss	Gain

(LOS 21.d)

Question #109 of 154

Question ID: 462334

The cumulative translation adjustment (CTA) is *closest to*:

✗ **A) a gain of US$440.**

✗ **B)** a loss of US$135.

✓ **C)** a loss of US$65.

Explanation

Australian Puddle Jumpers

Balance Sheet	2012 (A$)	Rate (A$/US$)	2012 (US$)
Cash	441	3.00	$147
A/R	330	3.00	$110
Maintenance Supplies	291	3.00	$97
Current assets	1062		$354
Net Fixed Assets	468	3.00	$156
Total Assets	1,530		$510
Accounts payable (A/P)	210	3.00	$70
Common Stock	720	2.50	$288
Retained Earnings	600	from I/S	$217
CTA			($65)
Total equities	1,320		$440
Total Liabilities and equity	1,530		$510
Income Statment	2012		
Sales	3,500	2.75	$1,272
Total costs	−2,900	2.75	$(1,055)
Net income			$217

(LOS 21.f)

Question #110 of 154

Question ID: 462360

Under the current rate method, common stock is translated by using the:

✗ A) **present value of weighted average rate.**

✗ B) exchange rate as of the balance sheet date.

✓ C) rate that existed when the equity was issued.

Explanation

The historical rate is used.

Question #111 of 154

Question ID: 462359

At what exchange rate are revenues and accounts receivable translated under the current rate method?

	Revenues	Accounts receivable
✗ A)	**Average rate**	**Historical rate**
✓ B)	Average rate	Current rate
✗ C)	Current rate	Current rate

Explanation

Under the current rate method, revenues are translated at the average rate; accounts receivable are translated at the current rate.

Question #112 of 154

Question ID: 462367

An important distinction between the temporal method and the current rate method is that:

✓ **A) the current rate method results in an adjustment to the equity account on the balance sheet. The temporal method results in a gain or loss appearing on the income statement.**

✗ **B)** monetary assets and liabilities are remeasured (temporal method) at historical rates but translated (current rate method) at current rates.

✗ **C)** depreciation and cost of goods sold (COGS) are a function of the current rate under translation (current rate method), but a function of the average rate under remeasurement (temporal method).

Explanation

The current rate method results in an adjustment to the equity account on the balance sheet. The temporal method results in a gain or loss appearing on the income statement. Depreciation and COGS are a function of the average rate under the current rate method, but a function of the historical rate under the temporal method. Monetary assets and liabilities are use the current rates under both methods.

Questions #113-118 of 154

Geocorp is a global corporation with operations in North America, Asia, and Europe. Its primary business is marketing industrial machinery for the construction industry. Geocorp has regional headquarters located in New York, Tokyo, and Paris. All North American and U.S operations report to its regional and world headquarters located in New York, while all Asian operations report to Tokyo, and all European operations report to Paris.

The following information is relevant to Geocorp's subsidiaries:

- Geocorp has a Canadian subsidiary that reports its results in Canadian dollars (CAD). The CAD is the functional currency.
- All domestic U.S. operations report their results in U.S. dollars (USD).
- All world-wide operations are reported in USD.
- Geocorp's Asian operations report their results in Japanese yen (JPY). The JPY is the functional currency.
- Geocorp has a Chinese subsidiary that reports its results in Chinese yuan renminbi (CNY). The USD is the functional currency.
- Geocorp's European headquarters (in Paris) operations report their results in euros (EUR). The EUR is the functional currency.
- Geocorp has a British subsidiary that reports its results in British pounds (GBP). The USD is the functional currency.

The following table is a summary of selected financial results from Geocorp's foreign operations:

All values are in millions	*CAD*	*JPY*	*CNY*	*GBP*	*EUR*
Revenues	50	5,000	250	150	700
Cost of goods sold (COGS)	20	2,700	110	100	480
Gross profit	30	2,300	140	50	220
Selling, general & administrative (SGA) expenses	18	1,000	52	29	200

EBIT	12	1,300	88	21	10
Cash	35	4,200	130	102	400
Accounts receivable	12	1,400	55	45	170
Inventory	20	3,900	135	123	300
Fixed assets	62	7,680	188	370	450
Accounts payable	27	3,300	76	68	350
Long-term debt	70	8,450	290	320	550
Common stock	10	2,000	150	50	350

The following exchange rates apply (USD per foreign currency unit):

Currency	*Historical Rate*	*Average Rate*	*December 31, 2002*
CAD	USD 0.7013	USD 0.6803	USD 0.6592
JPY	USD 0.0094	USD 0.0088	USD 0.0082
CNY	USD 0.1010	USD 0.1109	USD 0.1208
EUR	USD 0.9801	USD 1.0318	USD 1.0834
GBP	USD 1.4803	USD 1.5506	USD 1.6209

Question #113 of 154

Question ID: 462445

With respect to the Canadian subsidiary, what method should be used to value its revenues, what is the appropriate exchange rate, and what is the translated value (in USD)?

✗ **A) Current method, current rate, USD 33.0 million.**

✗ **B)** Temporal method, average rate, USD 34.0 million.

✓ **C)** Current method, average rate, USD 34.0 million.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Self-contained, independent subsidiaries reporting their results in the local currency that is also the functional currency use the current method. Revenues under the current method are translated using the average rate. Hence, 50 × 0.6803 = USD 34.0 million. (Study Session 6, LOS 21.e)

Question #114 of 154

Question ID: 462446

With respect to the Japanese subsidiary, what method should be used to value its accounts receivable, what is the appropriate exchange rate, and what is the translated value (in USD)?

✗ **A) Temporal method, current rate, USD 11.5 million.**

✗ **B)** Current method, average rate, USD 12.3 million.

✓ **C)** Current method, current rate, USD 11.5 million.

Explanation

Self-contained, independent subsidiaries reporting their results in the local currency that is also the functional currency use the current method. Assets under the current method are translated using the current rate. Hence, 1400 × 0.0082 = USD 11.5 million. (Study Session 6, LOS 21.e)

Question #115 of 154

Question ID: 462447

With respect to the European HQ subsidiary, what method should be used to value its SG&A expenses, what is the appropriate exchange rate, and what is the translated value (USD)?

✓ **A) Current method, average rate, USD 206.4 million.**

✗ **B)** Current method, current rate, USD 216.7 million.

✗ **C)** Temporal method, average rate, USD 206.4 million.

Explanation

Self-contained, independent subsidiaries reporting their results in the local currency that is also the functional currency use the current method. Expenses under the current method are translated using the average rate. Hence, 200 × 1.0318 = USD 206.4 million. (Study Session 6, LOS 21.e)

Question #116 of 154

Question ID: 462448

With respect to the British subsidiary, what method should be used to value its fixed assets, what is the appropriate exchange rate, and what is the translated value (USD)?

✓ **A) Temporal method, historical rate, USD 547.7 million.**

✗ **B)** Current method, current rate, USD 599.7 million.

✗ **C)** Current method, historical rate, USD 547.7 million.

Explanation

Self-contained, independent subsidiaries reporting their results in the local currency that is **NOT** the functional currency use the temporal method. Fixed assets under the temporal method are translated using the historical rate. Hence, 370 × 1.4803 = USD 547.7 million. (Study Session 6, LOS 21.e)

Question #117 of 154

Question ID: 462449

With respect to the Chinese subsidiary, what method should be used to value its long term debt, what is the appropriate exchange rate, and what is the translated value (in USD)?

✗ **A) Temporal method, historical rate, USD 29.3 million.**

✗ **B)** Current method, current rate, USD 35.0 million.

✓ **C)** Temporal method, current rate, USD 35.0 million.

Explanation

Self-contained, independent subsidiaries reporting their results in the local currency that is **NOT** the functional currency use the temporal method. Long-term debt under the temporal method is considered a monetary liability and is translated using the current rate. Hence, 290 × 0.1208 = USD 35.0 million. (Study Session 6, LOS 21.e)

Question #118 of 154

Question ID: 462450

Which of the following statements is *most* accurate with respect to accounting for inventory and cost of goods sold (COGS) using last-in first out (LIFO) under the temporal method?

✗ **A)** **Inventory is translated at the current rate while COGS is translated at historical rates.**

✓ **B)** Inventory is translated at historical rates, and COGS is translated at historical rates.

✗ **C)** Inventory is translated at historical rates, and COGS is translated at the current rate.

Explanation

If using LIFO, units sold during the year are the ones purchased during the year. Under the temporal method, COGS and inventory would be translated at historical rates. (Study Session 6, LOS 21.d)

Question #119 of 154

Question ID: 462462

In reality, what *best* describes the real value of non-monetary assets and liabilities in a hyperinflationary environment?

✗ **A)** **All non-monetary accounts are re-measured at the current rate.**

✓ **B)** Typically not affected because their local currency-denominated values increase to offset the impact of inflation.

✗ **C)** Typically not affected because their local currency-denominated values decrease to offset the impact of inflation.

Explanation

Typically not affected because their local currency-denominated values increase to offset the impact of inflation (i.e., real estate values typically rise with inflation).

Question #120 of 154

Question ID: 462358

Which of the following general statements is CORRECT with respect to the temporal method? Revenues and operating expenses (excluding COGS) are translated at the:

✗ **A)** **historical rate.**

✓ **B)** average rate.

✗ **C)** current rate.

Explanation

As a general rule for the temporal method, all revenues and operating expenses (excluding COGS) are translated using the average rate.

Questions #121-126 of 154

South Seas Inc, a subsidiary of Seven Seas Inc., reported its most recent performance in its local currency (LC) which is the functional currency. The reporting currency of Seven Seas is the U.S. dollar (USD). South Seas also paid a dividend of 16,000LC at year end, at which time the exchange rate was 2.00 LC/USD. Last year, Seven Seas reported balance sheet retained earnings of 90,000 USD for its South Seas subsidiary.

Rates	LC/US$
Current rate	2.00
Average rate	2.20
Historical rate	2.50
Historical rate for COGS	2.30
Historical rate for depreciation	2.10
Historical rate for ending inventory	2.30
Historical rate for fixed assets	2.10

	LC
Revenues	520,000
Cost of Goods Sold (COGS)	225,000
SG&A	100,000
Depreciation	80,000
Income Taxes	46,000
Net Income	69,000

The balance sheet for South Seas is given below.

	LC
Cash	25,000
Accounts Receivable	30,000
Inventory	35,000
Net Fixed Assets	500,000
Total Assets	590,000
Accounts Payable	20,000
Long term debt	100,000
Common Stock	250,000
Retained Earnings	220,000
Total Liabilities & Equity	590,000

Question #121 of 154

Question ID: 462336

What is the amount of income Seven Seas should report from its South Seas subsidiary?

✗ **A) 34,500 USD.**

✓ **B)** 31,400 USD.

✗ **C)** 27,600 USD.

Explanation

The current rate method is used when the Functional Currency is NOT the same as the Parent's Presentation (reporting) Currency. The temporal method is used when the Functional Currency = the Parent's Presentation Currency.

	LC	*Conversion*	*USD*	
Revenues	520,000	/2.20	236,364	average rate
COGS	225,000	/2.20	102,273	average rate
SG&A	100,000	/2.20	45,455	average rate
Depreciation	80,000	/2.20	36,364	average rate
Income Taxes	46,000	/2.20	20,909	average rate
Net Income	69,000		31,364	

(LOS 21.d)

Question #122 of 154

Question ID: 472481

The amount of retained earnings that Seven Seas will report on its balance sheet for its South Seas subsidiary is *closest* to:

✓ **A) 113,364 USD.**

✗ **B)** 121,364 USD.

✗ **C)** 129,364 USD.

Explanation

Dividends are translated at the rate 2LC/USD. Therefore, the 16,000 LC dividend is equivalent to 16,000LC / 2 = 8,000 USD. Net income less dividends equals the current period retained earnings of 31,364 USD − 8,000 USD = 23,364 USD). The balance sheet retained earnings is the sum of last year's retained earnings and the current period's retained earnings, or 90,000 + 23,364 = 113,364 USD.

(LOS 21.e)

Question #123 of 154

Question ID: 462338

The currency translation adjustment that results from the translation of South Sea's data is *closest* to?

✗ **A) zero because there is no currency translation adjustment under the current rate method.**

✓ **B)** 21,600 USD.

✗ **C)** −3,300 USD.

Explanation

	LC	*Conversion*	*USD*	
Cash	25,000	/2.00	12,500	current rate
Accounts Receivable	30,000	/2.00	15,000	current rate
Inventory	35,000	/2.00	17,500	current rate
Net Fixed Assets	500,000	/2.00	250,000	current rate
Total Assets	590,000		295,000	
Accounts Payable	20,000	/2.00	10,000	current rate
Long Term Debt	100,000	/2.00	50,000	current rate
Common Stock	250,000	/2.50	100,000	historical rate
Retained Earnings	220,000		113,364	answer from part 2
Translation Adjustment			21,636	plug
Total Liabilities & Equity	590,000		295,000	

(LOS 21.e)

Question #124 of 154

Question ID: 462339

If the temporal method is used, the retaining earnings is *closest* to:

✗ **A) 21,600 USD.**

✓ **B)** 120,800 USD.

✗ **C)** 90,000 USD.

Explanation

The retained earnings value is the plug figure. The value of total assets is $280,813. Subtracting the accounts payable, long-term debt, and common stock from the total assets leaves $120,813.

	LC	*Conversion*	*USD*	
Cash	25,000	/2.00	12,500	current rate
Accounts Receivable	30,000	/2.00	15,000	current rate
Inventory	35,000	/2.30	15,217	historical rate for inventory
Net Fixed Assets	500,000	/2.10	238,095	historical rate for fixed assets

Total Assets	590,000		280,813	
Accounts Payable	20,000	/2.00	10,000	current rate
Long Term Debt	100,000	/2.00	50,000	current rate
Common Stock	250,000	/2.50	100,000	historical rate
Retained Earnings	220,000		120,813	280,813 − 10,000 − 50,000 − 100,000
Total Liabilities & Equity	590,000		280,813	

(LOS 12.f)

Question #125 of 154

Question ID: 462340

If the functional currency is the US$ then the net income before a remeasurement is *closest* to:

✓ **A) 34,100 USD.**

✗ **B)** 4,700 USD.

✗ **C)** 8,000 USD.

Explanation

Adjust the income statement by the appropriate rates. For COGS and depreciation, historical rates were given. Average rate is used for all others.

	LC	*Conversion*	*USD*	
Revenues	520,000	/2.20	236,364	average rate
COGS	225,000	/2.30	97,826	historical rate for COGs
SG&A	100,000	/2.20	45,455	average rate
Depreciation	80,000	/2.10	39,095	historical rate for depreciation
Income Taxes	46,000	/2.20	20,909	average rate
Net Income before remeasurement	69,000		34,079	

(LOS 21.d)

Question #126 of 154

Question ID: 462341

If the functional currency had been to the US$, the currency exposure would have resulted in a:

✓ **A) remeasurement loss.**

✗ **B)** cumulative translation gain.

✗ **C)** remeasurement gain.

Explanation

When the functional currency is the reporting or presentation currency, the temporal method is applied to calculate the remeasurement. The foreign currency LC has appreciated from 2.50 LC/$ to 2.00 LC/$. There is a net monetary liabilities as the value of the cash and accounts receivables (LC 25,000 + LC 30,000 = LC 55,000) are less than the value of accounts payable and long-term debt (LC 20,000 +

LC 100,000 = LC 120,000). The foreign currency appreciation along with a net monetary asset liability exposure will result in a remeasurement loss.

Exposure	Foreign Currency	
Temporal Method:	Appreciating	Depreciating
Net monetary assets	Gain	Loss
Net monetary liabilities	Loss	Gain

(LOS 21.d)

Question #127 of 154

Question ID: 472479

The local currency is:

✗ **A)** **the preferred functional currency for subsidiaries that are highly integrated with the parent.**

✓ **B)** the same as the functional currency under the current rate method.

✗ **C)** translated into the functional currency under the current rate method.

Explanation

The local currency is best described as the currency of the country in which the foreign subsidiary is located. If a subsidiary is highly integrated with its parent or operating in a high-inflation environment, the functional currency is the parent's currency. Local currencies are remeasured under the temporal method.

Question #128 of 154

Question ID: 462404

The Schuldes Company had the following reported assets in euros at historical cost for the period ending December 31, 2005.

Cash	134
Accounts receivable	270
Inventory	404
Net fixed assets	1347
Total assets	2155

The exchange rate per was $0.8734 on January 1, 2005 and $0.9896 on December 31, 2005. The average exchange rate for the year 2005 was $0.8925. The total assets of Schuldes using the current rate method are:

✗ **A)** **$2,178.**

✓ **B)** $2,133.

✗ **C)** $1,923.

Explanation

With the current rate method all balance sheet items except common stock use the current exchange rate to translate the functional currency into the reporting currency.

2155 × $0.9896 = $2,133.

Questions #129-134 of 154

Neptune Corporation (Neptune) is a U.S. company located in Detroit, Michigan. Neptune supplies exhaust emission systems to manufacturers of passenger cars and light duty trucks. In January 2006, Neptune formed a wholly owned subsidiary, Continental Systems GmbH (Continental), to supply automotive manufacturers located throughout Europe. Continental is located in Stuttgart, Germany.

Continental's most recent financial statements, denominated in euros, are provided in Exhibit 1.

Exhibit 1: Continental Systems GmbH

Income statement

Year ended December 31

(in thousands)	**2008**
Sales revenue	76,000
Cost of goods sold	(48,000)
Administrative expense	(4,000)
Depreciation expense	(6,000)
Interest expense	(4,800)
Tax expense	(5,760)
Net income	7,440

Balance sheet

As of December 31

(in thousands)

Assets	**2008**	**2007**
Cash	8,800	8,000
Accounts receivable	44,000	42,000
Inventory	16,800	16,000
Fixed assets, at cost	97,200	88,000
Accumulated depreciation	(42,000)	(36,000)
Total assets	124,800	118,000

Neptune has net monetary assets and reports its consolidated financial statements in U.S. dollars. The euro has been consistently appreciating against the dollar.

Continental accounts for its inventory using the first-in, first-out (FIFO) cost flow assumption. Fixed assets consist of machinery, tools, and equipment. All of the fixed assets were acquired at the beginning of 2006.

All of Neptune's U.S. employees are covered by a defined benefit pension plan. The plan is noncontributory and the benefits are based on years of service and employee earnings. Both ABO and PBO currently exceed the fair value of pension plan assets.

Question #129 of 154

Question ID: 462374

Which of the following components of the projected benefit obligation is *most likely* to increase every year as a direct result of the employee working another year for the company?

✗ **A) Benefits paid.**

✓ **B)** Current service cost.

✗ **C)** Interest cost.

Explanation

The current service cost is the present value of new benefits earned by the employee working another year. Current service cost increases the PBO. Note that the interest cost increases every year regardless of whether the employee works another year or not. (Study Session 6, LOS 21.c)

Question #130 of 154

Question ID: 462375

Which of the following are the *most likely* impacts on gross profit margin and net profit margin, assuming the temporal method is used to remeasure Continental's financial statements?

✗ **A)** **Only gross profit margin will be higher.**

✗ **B)** Only net profit margin will be higher.

✓ **C)** Both will be higher.

Explanation

Under the temporal method, sales are remeasured at the average rate, and cost of goods sold is remeasured at the historical rate. Since the euro is appreciating relative to the dollar, sales will be higher when stated in dollars. Because cost of goods sold is remeasured at the historical rate, it does *not* reflect the appreciating euro. Therefore, appreciating sales, without a corresponding increase in cost of goods sold, will result in higher gross profit margin.

Under the temporal method, exposure is defined as the firm's net monetary asset or net monetary liability position. Continental is holding net monetary assets (monetary assets exceed monetary liabilities), and the position is increasing. Holding net monetary assets when the euro is appreciating will result in the recognition of a gain in the income statement. The gain results in higher net income and, thus, higher net profit margin. (Study Session 7, LOS 22.c)

Question #131 of 154

Question ID: 462376

Which of the following are the *most likely* impacts on the operating profit margin and the long-term debt-to-equity ratio, assuming the current rate method is used to translate Continental's financial statements?

✗ **A)** **Long-term debt-to-equity ratio will be higher.**

✗ **B)** Operating profit margin will be higher.

✓ **C)** Neither ratio will change.

Explanation

Under the current rate method, all revenues and all expenses are translated at the average rate. Consequently, the subtotals (gross profit, operating profit, and net profit) are translated at the average rate. Translating the numerator (operating profit) and the denominator (sales) at the same rate will have no impact on the ratio.

Under the current rate method, all assets and all liabilities are translated at the current rate. In order for the balance sheet equation to balance, total shareholders' equity must also be translated at the current rate. Translating the numerator (long-term debt) and the denominator (shareholders' equity) at the same rate will have no impact on the ratio. (Study Session 7, LOS 22.c)

Question #132 of 154

Question ID: 462377

When stated in U.S. dollars, would Continental *most likely* report a higher fixed asset turnover ratio and a higher quick ratio under the temporal method, as compared to the current rate method?

✗ **A)** **Only the quick ratio will be higher under the temporal method.**

✗ **B)** Both ratios will be higher under the temporal method.

✓ **C)** Only fixed asset turnover will be higher under the temporal method.

Explanation

Continental would report a higher fixed asset turnover ratio (sales/fixed assets) under the temporal method because sales are translated at the same rate under both methods (the average rate), but fixed assets would be translated at the lower historical rate (because the euro is appreciating) under the temporal method. Therefore, the ratio will be higher.

Continental would *not* report a higher quick ratio under the temporal method. Actually, the quick ratio would be the same under both methods. Continental's quick assets include cash and accounts receivable. Quick assets and current liabilities are converted at the current rate under both methods. (Study Session 7, LOS 22.c)

Question #133 of 154

Question ID: 462378

Which of the following statements about the temporal method and the current rate method is *least* accurate?

✗ **A)** **Net income is generally more volatile under the temporal method than under the current rate method.**

✓ **B)** Subsidiaries whose operations are well integrated with the parent will generally use the current rate method.

✗ **C)** Subsidiaries that operate in highly inflationary environments will generally use the temporal method under U.S. GAAP.

Explanation

Subsidiaries whose operations are well integrated with the parent will generally use the parent's currency as the functional currency. Remeasurement from the local currency to the functional currency is done with the temporal method. (Study Session 7, LOS 22.c)

Question #134 of 154

Question ID: 462379

If Neptune was to increase the discount rate used in calculating the pension obligations, which of the following would be *most* correct, concerning its net income and the funded status of the pension plan?

✓ **A)** **Higher net income, with a higher funded status.**

✗ **B)** Higher net income, with a lower funded status.

✗ **C)** Lower net income, with a higher funded status.

Explanation

Service cost, a component of pension expense, is a present value calculation. Consequently, an increase in the discount rate will lower the service cost. A lower service cost will result in lower pension expense. Lower pension expense will result in higher net income.

The funded status is equal to the difference in the fair value of the plan assets and PBO. Since service cost is also a component of PBO, an increase in the discount rate will result in a lower PBO. A lower PBO will result in a higher funded status (more funded). (Study Session 6, LOS 21.c)

Questions #135-140 of 154

Deborah Ortiz, CFA®, is the director of Global Research for F.E. Horton & Co. Ortiz recently hired two junior analysts, Tina Hirauye and Dominique Wilkins to assist in the financial statement analysis of global conglomerates. Hirauye and Wilkins are both Level II candidates in the CFA® Program, so Ortiz thought they would be the ideal people to work on a project dealing with consolidating the results of foreign operating units in the financial statements of the global parent.

Before starting on the project, Ortiz has a meeting with Hirayue and Wilkins to discuss the use of different currencies in a company's operations. At the meeting, Hirayue states that when analyzing multinational firms, there cannot be a difference between local and functional currencies. Wilkins disagrees with her and states that there can be a difference between local and functional currencies, but only if the parent of the subsidiary operates in a hyperinflationary environment. After another 30 minutes of discussion, Ortiz concludes the meeting by telling them to make sure they understand the different accounting rules for remeasurement and translation, under SFAS 52.

Hirauye and Wilkins are given projects involving three different firms:

- Molsan Industries is a Canadian multinational firm with a subsidiary in Japan. The subsidiary has operations in both Japan and Singapore.
- Tylo Corporation is a multinational firm based in France. Tylo does business on a global basis, but prepares and issues consolidated financial statements in U.S. dollars. Tylo has a subsidiary that does business in the United Kingdom. The majority of the cash that the subsidiary generates and expends is denominated in British Pounds (GBP).
- Neslarone is based in Switzerland and generates the majority of its cash in Swiss Francs (CHF). The firm issues and prepares its consolidated financial statements in U.S. dollars.

Hirauye and Wilkins spend the morning reviewing the details of their assignment and decide to take a break for lunch at a restaurant across the street from F.E. Horton & Co.'s headquarters. They agree that they have a challenging task and both are nervous about turning in their consolidated financial statements to Ortiz on the following day. At the restaurant, the two junior analysts run into two F.E. Horton senior analysts, Brad Windbigler and Elizabeth Alvarez, and the four of them decide to eat lunch together. Windbigler and Alvarez recently found out that they both passed Level III of the CFA® Exam, and, upon hearing about the task assigned by Ortiz, they are eager to help their two junior colleagues. Windbigler states that the current exchange rate is defined as the exchange rate between functional and reporting currencies at the balance sheet date, excluding all of a firm's hedging activities. Alvarez also tries to offer assistance by stating that the correct exchange rate to use for monetary assets and liabilities when applying the temporal method is the average rate. When lunch is over, Hirauye and Wilkins thank their colleagues for their advice and go back to work to finish their assignment.

Question #135 of 154

Question ID: 462303

Regarding the statements made at the meeting:

✗ **A) Hirauye's statement is incorrect; Wilkins' statement is correct.**

✓ **B)** Hirauye's statement is incorrect; Wilkins' statement is incorrect.

✗ **C)** Hirauye's statement is correct; Wilkins' statement is correct.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Hirauye and Wilkins both make incorrect statements regarding local and functional currencies. A foreign subsidiary may have a local currency but designate another currency as its functional currency. The functional currency is defined as the currency of the primary environment in which the subsidiary generates and expends cash, but the choice of the functional currency is ultimately a function of management's judgment. Wilkins is also incorrect because the rate of inflation does not necessarily have an impact on designated currencies. (Study Session 6, LOS 21.a)

Question #136 of 154

Question ID: 462304

Hirauye is working on consolidating the financial statements of Molsan Industries' Japanese subsidiary. Under SFAS 52, regarding *Foreign Currency Translation*, if:

✗ **A)** **more than half of the subsidiary's revenue is from Japanese sources, then the results of the Singapore operation are translated into Japanese yen and then translated into Canadian dollars.**

✓ **B)** management determines that the subsidiary's functional currency is the Japanese yen, the results of the Singapore operation are first remeasured into Japanese yen and then translated into Canadian dollars.

✗ **C)** management determines that the subsidiary's functional currency is the Singapore dollar, then the results of the Singapore operation are remeasured into Canadian dollars.

Explanation

The functional currency is determined by management. Financial data are remeasured into the functional currency chosen by management and then translated into the reporting currency. (Study Session 6, LOS 21.a)

Question #137 of 154

Question ID: 462305

Wilkins has been tasked with analyzing Tylo Corporation, and is trying to distinguish between the various currencies employed in Tylo's operations. Concerning the UK subsidiary's functional and reporting currencies the:

✗ **A)** **parent firm (Tylo) is headquartered in France, therefore the functional currency is the Euro, and the reporting currency is the U.S. dollar.**

✓ **B)** functional currency is the British Pound; reporting currency is the U.S. dollar.

✗ **C)** functional currency and reporting currency are the U.S. dollar.

Explanation

The functional currency is defined as the currency of the primary economic environment in which the subsidiary generates and expends cash. Although the functional currency can be chosen by management, because we are told that Tylo's UK subsidiary generates and expends cash in British Pounds, the British Pound is the best choice for the functional currency. The reporting currency is the currency in which the parent firm prepares final consolidated statements, which in this case is the U.S. dollar. (Study Session 6, LOS 21.a)

Question #138 of 154

Question ID: 462306

Ortiz had told the junior analysts to make sure they understand the different accounting rules under SFAS 52. When referring to foreign exchange rates, the difference between remeasurement and translation is that remeasurement:

✗ **A)** **and translation refer to the same process of translating the functional currency into the reporting currency.**

✓ **B)** refers to the conversion of local currency into the functional currency; translation is the conversion of the functional currency into the reporting currency.

✗ **C)** is used to describe historical exchange rates while translation is used for current rates.

Explanation

Translation is between functional and reporting currency. Remeasurement occurs between local and functional currencies. (Study Session 6, LOS 21.a)

Question #139 of 154

Question ID: 462307

Regarding the statements made at lunch:

- ✗ **A)** **Windbigler's statement is correct; Alvarez's statement is correct.**
- ✗ **B)** Windbigler's statement is incorrect; Alvarez's statement is incorrect.
- ✓ **C)** Windbigler's statement is correct; Alvarez's statement is incorrect.

Explanation

Windbigler's statement is correct. The current rate is defined as the market rate in effect at the balance sheet date. Hedging activities do not affect the rate, but affect the gain or loss from changes in exchange rates. Alvarez's statement is incorrect. The correct exchange rate to use for monetary assets and liabilities when applying the temporal method is the *current rate*. (Study Session 6, LOS 21.c)

Question #140 of 154

Question ID: 462308

Wilkins and Hirauye are working on constructing the consolidated statements for Neslarone. They know that after they convert from Swiss Francs (CHF) to U.S. dollars (USD), they will be left with a foreign currency adjustment that needs to be included on the financial statements. To convert from CHF to USD, the analysts should use the:

- ✗ **A)** **temporal method and they should record the foreign currency adjustment on the income statement.**
- ✗ **B)** current rate method and they should record the foreign currency adjustment on the income statement.
- ✓ **C)** current rate method and they should record the foreign currency adjustment on the balance sheet.

Explanation

Neslarone is based in Switzerland and generates the majority of its cash in CHF, meaning the local and functional currencies are both CHF. The firm issues financial reports in USD, so the dollar is the reporting currency. The process of converting from the functional currency to the reporting currency is translation and the correct method to use is the current rate method. When using the current rate method, the foreign currency adjustment is recorded in the equity section of the balance sheet. (Study Session 6, LOS 21.d)

Question #141 of 154

Question ID: 462313

Edmonton Oilfield Supply has made an equipment sale in Venezuela in the amount of VEF 15,000,000. On the day of the sale, the exchange rate is 1.7519 VEF per 1 Canadian dollar. 90 days later, when the Venezuelan firm pays for the equipment, the exchange rate is 1.6326. As a result of the change in the exchange rate, Edmonton will recognize a:

- ✗ **A)** **loss of $1,789,500.**
- ✗ **B)** gain of $1,096,104.
- ✓ **C)** gain of $625,666.

Explanation

On the day of the sale, Edmonton will record an account receivable of 15m/1.7519 = $8,562,133. When the payment is received and converted to CAD, the realized amount will be 15m/1.6326 = $9,187,799. As a result of the appreciating VEF, Edmonton will realize a gain of $9,187,799 − 8,562,133 = CAD 625,666.

Question #142 of 154

Question ID: 462392

The Herlitzka Company, a U.S. multinational firm, has a 100% stake in a Swiss subsidiary. The Swiss franc (SF) has been determined to be the functional currency. All the common stock of the subsidiary was issued at the beginning of the year and the subsidiary uses the FIFO inventory cost-flow assumption. In addition, the value of the SF is as follows:

Beginning of year	$0.5902
Average throughout the year	$0.6002
End of year	$0.6150

The SF-based balance sheet and income statement data for the Swiss subsidiary are as follows:

Accounts receivable	= 3,000
Inventory	= 4,000
Fixed assets	= 12,000
Accounts payable	= 2,000
Long-term debt	= 5,000
Common stock	= 10,000
Retained earnings	= 2,000
Net income	= 2,000

The translated value of accounts receivable and inventory respectively are:

✓ **A) $1,845 and $2,460.**

✗ **B)** $1,845 and $2,401.

✗ **C)** $1,801 and $2,401.

Explanation

The basis for using the current rate method is when Functional Currency is NOT the same as Parent's Presentation (reporting) Currency. The basis for using the temporal method is when Functional Currency = Parent's Presentation Currency.

Since the SF is the functional currency, then the current rate method is employed to translate the SF amounts into USD. Hence, A/R = 0.615 × 3,000 = $1,845 and 0.615 × 4,000 = $2,460.

Question #143 of 154

Question ID: 462464

(Assume U.S. GAAP for this question.) For a subsidiary in a hyperinflationary economy, the functional currency should be the:

✓ **A) Parent's currency.**

✗ **B)** Local currency.

✗ **C)** Subsidiary's operating currency.

Explanation

The functional currency should be the parent's currency. Under IFRS, the firm would restate the financials for inflation, and then translate under the current rate method.

Question #144 of 154

Question ID: 462388

The Herlitzka Company, a U.S. multinational firm, has a 100% stake in a Swiss subsidiary. The U.S. dollar (USD) has been determined to be the functional currency. All the common stock of the subsidiary was issued at the beginning of the year and the subsidiary uses the weighted-average inventory cost-flow assumption. In addition, the value of the SF is as follows:

Beginning of year	\$0.5902
Average throughout the year	\$0.6002
End of year	\$0.6150

The SF-based balance sheet and income statement data for the Swiss subsidiary are as follows:

Accounts receivable	= 3,000
Inventory	= 4,000
Fixed assets	= 12,000
Accounts payable	= 2,000
Long-term debt	= 5,000
Common stock	= 10,000
Retained earnings	= 2,000
Net income	= 2,000

The total value of net monetary assets is equal to:

✓ **A) -4,000 SF.**

✗ **B)** 12,000 SF.

✗ **C)** 3,000 SF.

Explanation

Monetary assets and liabilities include cash, A/R, A/P and Long-term debt. Hence, net monetary assets is equal to 3,000 − (2,000 + 5,000) = -4,000 SF.

Question #145 of 154

Question ID: 462463

A hyperinflationary economy is typically defined as one that has:

✗ **A) cumulative inflation that exceeds 100% over a twelve-year period.**

✗ **B)** an inflation rate that exceeds 10% per year for three consecutive years.

✓ **C)** cumulative inflation that exceeds 100% over a three-year period.

Explanation

The typical definition is that cumulative inflation exceeds 100% over a three-year period.

Question #146 of 154

Question ID: 462465

Which translation method should be used under a hyperinflationary economy when using U.S. GAAP?

✗ **A)** **All-current, because dividends are translated at the rate that applied when they were issued.**

✓ **B)** Temporal, because all non-monetary accounts are re-measured at the historical rate.

✗ **C)** Monetary/non-monetary, because all monetary accounts are translated at the historical rate.

Explanation

The temporal method is more appropriate because all non-monetary accounts are remeasured at the historical rate. Under IFRS, the financials would be restated for inflation, and then translated under the current rate method.

Question #147 of 154

Question ID: 462309

Sycamore Systems sold $5 million worth of software on December 1, 20X1 to a Japanese company with payment denominated in Japanese yen to be received in two months. Sycamore's year end is 31st December. Payment was received on 31 Jan 20X2.

Exchange rates	(1 USD)
1 Dec 20X1	95
31 Dec 20X1	90
31 Jan 20X2	35

The amount of transaction gain/loss recorded by Sycamore on its income statement for the year ending 31 Dec 20X1 is *closest to*:

✗ **A)** **loss of $300,000.**

✓ **B)** gain of $280,000.

✗ **C)** gain of $580,000.

Explanation

Sale amount = $5 million × 95 = 475 million yen. Accounts receivable on sale date = $5 million.

Accounts receivable at year-end = 475 million yen/90 = $5.28 million

The appreciation of the yen resulted in a gain of $280,000 on the balance sheet date and would be recognized in the income statement.

Questions #148-153 of 154

Navratov Corp. is a designer and manufacturer of high end sporting goods. The majority of the firm's business comes from Olympic athletes from Russia and the United States. On January 1, 2003, Navratov was purchased by a U.S. competitor, Evert Industries. Because Evert's business focuses on professional athletes in North America and Asia, Evert's management feels the acquisition of Navratov is a natural extension of their business and that buying the Russian firm should generate economies of scale.

Peter Capriati is an analyst for Evert and has been assigned the task of integrating Navratov's financial statements into Evert's. Capriati knows that Evert's management pays a great deal of attention to making sure the firm's financial ratios are above the industry average. Because Navratov's sales are split evenly between the U.S. and Russia, management has given him the flexibility to designate the either the Ruble (Navratov's local currency) or the U.S. dollar (Evert's reporting currency) as Navratov's functional currency. As a result of choosing the functional currency, Capriati will use either the temporal or current rate method to convert Navratov's financial statements, depending on which method will have the most favorable impact on Evert's financial ratios.

Selected financial data for Navratov Corp is shown below:

Navratov Corporation Income Statement (in Russian Rubles) 12 months ended December 31, 2003	
Revenue	7,400,000
Cost of Goods Sold (COGS)	(5,200,000)
Depreciation	(1,200,000)
Taxes	(250,000)
Net Income	750,000

Navratov Corporation Balance Sheet (in Russian Rubles) December 31, 2002			
Assets		***Liabilities and Equity***	
Cash	500,000	Accounts Payable	3,450,000
Accounts Receivable	2,500,000	Long Term Debt	5,000,000
Inventory	3,700,000	Common Stock	3,500,000
Net Fixed Assets	6,000,000	Retained Earnings	750,000
Total Assets	12,700,000	Total Liabilities and Equity	12,700,000

Navratov Corporation Balance Sheet (in Russian Rubles) December 31, 2003			
Assets		***Liabilities and Equity***	
Cash	1,000,000	Accounts Payable	2,000,000
Accounts Receivable	2,500,000	Long Term Debt	5,000,000

Inventory	3,700,000	Common Stock	3,500,000
Net Fixed Assets	4,800,000	Retained Earnings	1,500,000
Total Assets	12,000,000	Total Liabilities and Equity	12,000,000

- Navratov Corp. did not pay dividends in 2003.
- The common stock was acquired on January 1, 2002.
- January 1, 2003 retained earnings in USD is $300,000.
- Depreciation is being taken on a straight-line basis over ten years for equipment which was acquired on January 1, 2002, at a cost of 12,000,000 rubles.
- Navratov uses FIFO inventory accounting and goods were sold evenly throughout the year. The average rate applicable to inventory and COGS is $0.37 / ruble.

Exchange rates:

- January 1, 2002, $0.40 / ruble
- January 1, 2003, $0.40 / ruble
- June 30, 2003, $0.37 / ruble (avg. rate)
- December 31, 2003, $0.33 / ruble

Question #148 of 154

Question ID: 462417

Which of the following statements about the temporal method and the current rate method is least accurate?

✓ **A)** **Subsidiaries whose operations are well integrated with the parent will generally use the current rate method.**

✗ **B)** Subsidiaries that operate in highly inflationary environments will generally use the temporal method under U.S. GAAP.

✗ **C)** Net income is generally more volatile under the temporal method than under the current rate method.

Explanation

Subsidiaries whose operations are well integrated with the parent will generally use the parent's currency as the functional currency. Remeasurement from the local currency to the functional currency is done with the temporal method. (Study Session 6, LOS 21.d)

Question #149 of 154

Question ID: 462418

If Capriati uses the current rate method to translate Navratov's income statement, the net profit margin will be:

✗ **A)** **11.7%.**

✗ **B)** 8.6%.

✓ **C)** 10.1%.

Explanation

The net profit margin is a pure income statement ratio, meaning it will be unaffected by the application of the current rate method. The calculation is shown below:

Under the current rate method, all income statement accounts will be translated at the average rate.

Revenue	7,400,000	$0.37	$2,738,000
Cost of Goods Sold (COGS)	(5,200,000)	$0.37	(1,924,000)
Depreciation	(1,200,000)	$0.37	(444,000)
Taxes	(250,000)	$0.37	(92,500)
Net Income	750,000	$0.37	**$277,500**

Note that under the current rate method, since all income statement accounts are translated at the same average rate, you do not have to translate the income statement to get the correct answer. (750,000 / 7,400,000) = 10.1%. (Study Session 6, LOS 21.e)

Question #150 of 154

Question ID: 462419

What is the difference in the translated receivables turnover ratio for Navratov Corp. between the temporal and current rate methods? The receivables turnover rate is:

- ✓ **A) the same under both methods.**
- ✗ **B)** lower under the current rate method by 0.30x.
- ✗ **C)** higher under the current rate method by 0.36x.

Explanation

The receivables turnover ratio is calculated as (sales / receivables). Under the both the current rate and temporal methods, sales are translated at the average rate, while receivables are translated at the current rate. Since both the sales and receivables components are translated at the same rate, there will be no difference in the ratios between the two methods. (Study Session 6, LOS 21.e)

Question #151 of 154

Question ID: 462420

What is the difference in the total asset turnover ratio for Navratov Corp. between the temporal and current rate methods? The total asset turnover ratio is:

- ✗ **A) lower under the current rate method.**
- ✗ **B)** the same under both methods.
- ✓ **C)** higher under the current rate method.

Explanation

The total asset turnover ratio = (sales / total assets)

We can see from the exchange rates that the Russian ruble is depreciating (it takes fewer dollars to buy a ruble). With a depreciating local currency, sales are going to be the same under either method, since sales are translated at the average rate. Assets on the other hand will be higher under the temporal method, and lower under the current rate method. This is because all assets are translated at the current rate under the current rate method (which has the lower exchange rate), and at different rates under the temporal method (which is has fixed assets converted at the higher historical rate). With the same numerator and lower denominator, the current rate method will lead to the higher total asset turnover ratio. (Study Session 6, LOS 21.e)

Question #152 of 154

Question ID: 462421

Given the observed appreciation or depreciation of the ruble versus the U.S. dollar, which of the following statements regarding Navratov's leverage ratios under the temporal method compared to the current rate method is *most* accurate? The temporal method will lead to a:

✓ **A)** **lower debt-to-equity ratio and a lower debt-to-capital ratio.**

✗ **B)** higher debt-to-equity ratio and a higher debt-to-capital ratio.

✗ **C)** higher debt-to-equity ratio and a lower debt-to-capital ratio.

Explanation

Since it is taking fewer dollars to buy a ruble, the exchange rate is depreciating.

Both the debt-to-equity and debt-to-capital ratios will be lower under the temporal method versus the current rate method if a foreign currency is depreciating. Under both methods, long term debt and accounts payable are both translated at the current exchange rate, so those are the same.

Equity under the temporal method is effectively translated at a mixed rate under the temporal method, and the current rate under the current rate method. Since the currency is depreciating, the equity value will be higher under the mixed rate scenario. With the same debt and higher equity, the temporal method will lead to a lower debt-to-equity ratio than the current rate method.

Assets under the temporal method are also effectively translated at a mixed rate under the temporal method, and the current rate under the current rate method. Since the currency is depreciating, the asset value will be higher under the mixed rate scenario. With the same debt and higher assets, the temporal method will lead to a lower debt-to-capital ratio than the current rate method. (Study Session 6, LOS 21.e)

Question #153 of 154

Question ID: 462422

Capriati has completed his research and has summarized his findings in a report for Evert's management. Which of the statements made in Capriati's report is *least* accurate?

✗ **A)** **The statement of cash flows for Navratov Corp should be the same under both the temporal and current rate methods of translation.**

✗ **B)** A depreciating foreign currency will have a smaller impact on Evert's consolidated financial statements than an appreciating foreign currency.

✓ **C)** Evert would prefer the temporal method for reporting its gross profit margin if the Russian Ruble was depreciating.

Explanation

If the ruble was depreciating, Evert would report a higher gross profit margin under the current rate method. Under both the temporal and current rate methods, revenues are translated at an average rate, while COGS are translated at a historical rate under the temporal method and an average rate under the current rate method. A depreciating currency means that COGS would be higher under the temporal method, resulting in a lower gross profit margin. The other statements are true - an appreciating foreign currency tends to have the largest impact on the parent company's financials and the statement of cash flows should theoretically be the same under both methods but flow effects from changing rates will have an impact on reporting currency methods. (Study Session 6, LOS 21.d)

Question #154 of 154

Question ID: 462414

The Precision Screen Printers (PSP) Company has a foreign subsidiary, the Acer Tool & Die Company, located in the country of Rolivia. The currency of Rolivia is the Chad. The balance sheet and income statement of Acer Tool & Die Company for the year-ended December 31, 2002, is shown below. The balance sheet has been restated using the U.S. dollar as the functional currency.

Acer Tool & Die Company Balance Sheet

As of December 31, 2002

	Chad (millions)	*Exchange Rate (Chad/US$)*	*U.S. $ (millions)*
Cash	20	0.25	$80
Accounts receivable	30	0.25	120
Inventory	100	0.3125	320
Fixed assets (net)	500	0.3333	1,500
Total assets	650		$2,020
Accounts payable	50	0.25	$200
Capital stock	380	0.3333	1,140
Retained earnings	220	--	680
Total liabilities and equity	650		$2,020

Acer Tool & Die Company Income Statement

For year ending December 31, 2002

(Amounts in millions of Chad)

Revenues	1,000
Cost of sales	700
Depreciation expense	50
Selling expense	30
Net income	220

The exchange rate at the beginning of 2002 was 0.3333 Chad/US$. The exchange rate at the end of 2002 was 0.25 Chad/US$. The average rate for 2002 is 0.3125 Chad/US$. Beginning inventory is 90 Chad. Acer Tool & Die uses FIFO inventory valuation and depreciates fixed assets using the straight-line method.

Using the current rate method for the Acer Tool & Die Company, what is the value of total assets after translation?

- ✗ **A) $1,950.**
- ✓ **B)** $2,600.
- ✗ **C)** $2,020.

Explanation

With the current rate method, all balance sheet items except for common stock are translated at the current rate. Total assets = 650 / 0.25 = $2,600.