

CHAPTER 10**MULTINATIONAL OPERATIONS**

1. (A) ROE will most likely decline.

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 ratio falls.

(Module 10.6, LOS 10.f)

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2. (B) under the current rate method, revenues and expenses are translated at the exchange rate that existed when the underlying transaction occurred.

Explanation

Under the current rate method, revenues and expenses are translated at the exchange rate that existed when the underlying transaction occurred. (Though, for practical reasons, an average exchange rate is often used to translate income items.) Under the temporal method, monetary assets and monetary liabilities are translated at the current exchange rate. Under the current rate method, while shareholder's equity (as a whole, including CTA) is translated at the current rate, common stock is translated at historical exchange rate.

(Module 10.5, LOS 10.e)

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3. (B) Tax expense

Explanation

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.

(Module 10.6, LOS 10.f)

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CFA[®]**4. (C) \$5,902 and \$3,075.****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, 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. $10,000 \times 0.5902 = \$5,902$ for common stock and $5000 \times 0.6150 = \$3,075$ for long term debt.

(Module 10.6, LOS 10.f)

Related Material[SchweserNotes - Book 2](#)**5. (A) 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.

(Module 10.4, LOS 10.e)

Related Material[SchweserNotes - Book 2](#)**6. (C) Parent's 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.

(Module 10.7, LOS 10.g)

Related Material[SchweserNotes - Book 2](#)**7. (B) either higher or lower 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.

(Module 10.6, LOS 10.f)

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8. (A) **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.

(Module 10.3, LOS 10.e)

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9. (B) **\$2,133.**

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.

$$2155 \times \$0.9896 = \$2,133.$$

(Module 10.6, LOS 10.f)

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10. (C) **quickly deteriorate and the local currency will be rapidly depreciating against the presentation currency.**

Explanation

Purchasing power and Deadoa currency will depreciate.

(Module 10.7, LOS 10.g)

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11. (C) **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.**

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.

(Module 10.4, LOS 10.e)

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12. (B) **The ratio will be lower.**

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.

(Module 10.6, LOS 10.f)

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13. (C) **Temporal, because all non-monetary accounts are re-measured 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.

(Module 10.7, LOS 10.g)

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14. (C)

Average rate	Current rate
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Explanation

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

(Module 10.4, LOS 10.e)

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15. (C) **decline by 15%.**

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 $(0.6329 / 0.7484) - 1 = -0.15$.

(Module 10.2, LOS 10.c)

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16. (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.

(Module 10.7, LOS 10.g)

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

Explanation

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

(Module 10.3, LOS 10.e)

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18. (A) **Quick ratio.**

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. Inventory turnover ratio and current ratio both would be similarly affected as they rely on the value of inventory.

(Module 10.6, LOS 10.f)

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19. (A) temporal method because all non-monetary accounts are translated at the historical rate.

Explanation

The temporal rate method is most appropriate because the value of non-monetary assets and liabilities is translated at the historical rate. Under IFRS, the firm restates the financials using an inflation index, and then translates using the current rate method.

(Module 10.3, LOS 10.e)

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20. (B) Return on equity.

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.

(Module 10.6, LOS 10.f)

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21. (C) is remeasured into the reporting currency under 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 local currency is remeasured into the functional currency under the temporal method. The functional currency is translated into the reporting currency using the current rate method.

(Module 10.1, LOS 10.a)

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	Temporal method	Current rate method
(A)	Income statement	Balance sheet

Explanation

Currency translation gain or loss appears on the income statement under the temporal method and the balance sheet under the current rate method.

(Module 10.1, LOS 10.f)

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CFA[®]**23 (C) gain of \$280,000.****Explanation**

Sale amount = \$5 million x 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.

(Module 10.1, LOS 10.b)

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24. (C) parent firm's home currency for self-contained independent foreign subsidiaries.**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.

This statement is incorrect, both remaining statements are correct regarding rules that govern the determination of the functional currency of subsidiaries.

(Module 10.4, LOS 10.e)

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25. (C) results in non-monetary asset values that are a better proxy for the economic values of those assets.**Explanation**

The temporal method results in non-monetary asset values that are a better proxy for the economic values of those assets than those obtained under the current rate method. Both methods convert revenues and SG&A at the average rate so there could be no clear preference when considering these measures.

(Module 10.7, LOS 10.g)

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26. (A) average rate.**Explanation**

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

(Module 10.3, LOS 10.e)

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CFA[®]**27. (A) historical rates at the time of the transaction.****Explanation**

As a general rule in using the temporal method, nonmonetary assets are translated using the historical rate at the time of the transaction.

(Module 10.3, LOS 10.e)

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

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.

(Module 10.3, LOS 10.e)

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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 Hirauye and Wilkins to discuss the use of different currencies in a company's operations. At the meeting, Hirauye 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 two different firms:

- Molsan Industries is a Canadian multinational firm with a subsidiary in Japan. The subsidiary has operations in both Japan and Singapore.
- 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.

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

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.

(Module 10.1, LOS 10.a)

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30. (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.**

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.

(Module 10.1, LOS 10.a)

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31. (A) **refers to the conversion of local currency into the functional currency; translation is the conversion of the functional currency into the reporting currency.**

Explanation

Translation is between functional and reporting currency. Remeasurement occurs between local and functional currencies.

(Module 10.1, LOS 10.a)

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32. (A) **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.

(Module 10.1, LOS 10.a)

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33. (C) **Typically not affected because their local currency-denominated values increase 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).

(Module 10.7, LOS 10.g)

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34. (C) **low balance sheet values for long term liabilities.**

Explanation

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.

(Module 10.7, LOS 10.g)

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35. (B) **local currency is the functional currency.**

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.

(Module 10.3, LOS 10.e)

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CFA[®]**36. (A) \$1,845 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 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 = $\$0.615 \times 3,000 = \$1,845$ and Inventory = $\$0.6002 \times 4,000 = \$2,401$.

(Module 10.6, LOS 10.f)

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

(Module 10.3, LOS 10.e)

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38. (A) \$715.**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 rate, and dividends are translated at the rate that applied when they were paid. Hence: $1.58(\pounds 500) - 1.50(\pounds 50) = \715 .

(Module 10.4, LOS 10.e)

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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, 2005, is shown below. The balance sheet has been restated using the U.S.

Acer Tool & Die Company Balance Sheet As of December 31, 2005

	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, 2005
(Amounts in millions of Chad)**

Revenues	1,000
Cost of sales	700
Depreciation expense	50
Selling expense	30
Translation gain (or loss)	
Net income	220

Acer has determined that the exchange rate exposure at the beginning of 2005 is –260 Chad.

The exchange rate at the beginning of 2005 was 0.3333 Chad/US\$ and that is the historical rate applicable to beginning inventory of 90 Chad. The exchange rate at the end of 2005 was 0.25 Chad/US\$. The average rate for 2005 is 0.3125 Chad/US\$. Purchases occurred evenly throughout the year. Acer Tool & Die uses FIFO inventory valuation and depreciates fixed assets using the straight-line method. Assume that retained earnings at year end 2004 were zero, the historical exchange rate for depreciation is 0.333, and no dividends were paid during 2005.

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39. (A) **\$2,222.00**

Explanation

Purchases = COGS – Beginning inventory + ending inventory = 710 Chad

	Chad	Conversion	U.S. \$
Beginning inventory	90	0.3333	\$270
Purchases	710	0.3125	2,272
Ending inventory	100	0.3125	320
COGS	700		\$2,222

(Module 10.6, LOS 10.f)

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40. (B) **\$52 loss.**

Explanation

Remeasured income statement under temporal method:

Revenues = $1000 / 0.3125 = 3200$

COGS = 2222 (from previous question)

Depreciation = $50 / 0.3333 = 150$

Selling expense = $30 / 0.3125 = 96$

Income before remeasurement gain = $3200 - 2222 - 150 - 96 = 732$

Net income = 680 (= retained earnings at year end 2005 – retained earnings at year end 2004)

Remeasurement gain/loss = $680 - 732 = -52$

(Module 10.6, LOS 10.f)

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41. (C) **the same as 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.

(Module 10.1, LOS 10.a)

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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 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 for common stock	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

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42. (B) 31,400 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	

(Module 10.4, LOS 10.d)

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43. (C) 21,600 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	220,00		113,364	Note 1
Translation Adjustment			21,636	Plug
Total Liabilities & Equity	590,00		295,000	

Note 1: Ending RE = Beginning RE (given USD 90,000) + NI (calculated 31,364) - Div (16000/2 = 8000) = USD 113364

(Module 10.4, LOS 10.d)

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44. (B) 120,800 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	

(Module 10.4, LOS 10.d)

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45. (C) 34,100 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	38,095	historical rate for depreciation
Income Taxes	46,000	/2.20	20,909	average rate
Net Income Before Translation Gain/Loss	69,000		34,079	

(Module 10.4, LOS 10.d)

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46. (C) **current rate method, the foreign currency translation gain or loss appears on the parent firm's income statement.**

Explanation

Under the current rate method, the foreign currency translation gain or loss appears on the parent firm's balance sheet in the equity accounts.

(Module 10.4, LOS 10.e)

Related Material

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47. (C) **inventory.**

Explanation

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

(Module 10.3, LOS 10.e)

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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 declared by Kasmatsu	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 \$2million	

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

48. (B) The current rate 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.

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Under US 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.

(Module 10.4, LOS 10.e)

Related Material

[SchweserNotes - Book 2](#)

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

Explanation

Examination of the history of the exchange rate shows that both the year-end and average exchange rates are lower in 2005 than in 2004 (lower in that the yen has weakened vs. the USD). Therefore, Kasamatsu has to earn more yen than it did in the previous year for WB to be able to report the same dollar amount of net income. This means that the true economic performance of Kasamatsu is understated when viewed as a component of WB's net income.

(Module 10.4, LOS 10.e)

Related Material

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50. (B) **translated at the current rate.**

Explanation

As a general rule in using the temporal method, monetary assets are translated using the current rate.

(Module 10.3, LOS 10.e)

Related Material

[SchweserNotes - Book 2](#)

51. (A) **decrease.**

Explanation

Sopgate's profits are expected to grow at a faster rate for lower tax rate regions as compared to higher tax regions. Hence the effective tax rate can be expected to decrease.

(Module 10.8, LOS 10.h)

Related Material

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52. (B) **company's assets, liabilities, and future sales.**

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.

(Module 10.8, LOS 10.j)

Related Material

[SchweserNotes - Book 2](#)

CFA[®]**53. (C) mostly independent from the parent.****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.

(Module 10.1, LOS 10.a)

Related Material[SchweserNotes - Book 2](#)**54. (B) 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.

(Module 10.6, LOS 10.f)

Related Material[SchweserNotes - Book 2](#)**55. (A) Nonmonetary liabilities are translated at the historical rate of exchange.****Explanation**

Under the current rate method, all liabilities are translated at the current rate of exchange.

(Module 10.4, LOS 10.e)

Related Material[SchweserNotes - Book 2](#)**56. (C) All pure balance sheet ratios are affected by the all-current translation method.****Explanation**

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

(Module 10.6, LOS 10.f)

Related Material[SchweserNotes - Book 2](#)

CFA[®]**57. (A) \$2,600.****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.

(Module 10.6, LOS 10.f)

Related Material

[SchweserNotes - Book 2](#)

58. (C) The receivables turnover ratio is identical under both the temporal method and the current rate method.**Explanation**

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

When using FIFO and the temporal method we assume that the appropriate rates to use for cost of goods sold (COGS) are the older historical rates. The average rate is used for COGS under the current rate method. If the local currency depreciates, COGS would be higher under the temporal method.

With an appreciating currency the fixed asset turnover ratio (sales / fixed assets) will be higher using the temporal method because the temporal method uses the historical rate for fixed assets whereas the current rate method uses the current rate. They both use the same average rate for sales.

(Module 10.6, LOS 10.f)

Related Material

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59. (B) Depreciation in the reporting currency under the current rate method is higher than under the temporal method if the local currency has appreciated.**Explanation**

Fixed assets are relatively understated under the temporal method if the local currency appreciates as they are translated at the weaker historic rate. The leverage ratio will be unaltered under the current rate method as it is a pure balance sheet ratio and hence all translated at the current rate.

(Module 10.6, LOS 10.f)

Related Material

[SchweserNotes - Book 2](#)

CFA[®]**60. (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).

(Module 10.6, LOS 10.f)

Related Material

[SchweserNotes - Book 2](#)

61. (A) rate that existed when the equity was issued.**Explanation**

The historical rate is used.

(Module 10.3, LOS 10.e)

Related Material

[SchweserNotes - Book 2](#)

62. (A) 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.

(Module 10.4, LOS 10.e)

Related Material

[SchweserNotes - Book 2](#)

63. (A) \$1,845 and \$2,460.**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, $A/R = 0.615 \times 3,000 = \$1,845$ and $0.615 \times 4,000 = \$2,460$.

(Module 10.6, LOS 10.f)

Related Material

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64. (A) **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.

(Module 10.6, LOS 10.f)

Related Material

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65. (B) **-4,000 SF.**

Explanation

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

(Module 10.6, LOS 10.f)

Related Material

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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 A\$/US\$ 2.50, the average rate during the year was A\$/US\$ 2.75 and A\$/US\$ 3.0 on Dec. 31, 2012.

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

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

66. (B) \$1,272.

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

(Module 10.4, LOS 10.d)

Related Material

[SchweserNotes - Book 2](#)

67. (A) \$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: $(330 / 3) = 110$

(Module 10.4, LOS 10.d)

Related Material

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68. (B) cumulative translation adjustment loss.

Explanation

APJ shows a net asset:

Total assets	$A\$1,530 / (3.00 \text{ A\$/US\$}) = \text{US\$}510$
Total liabilities	$A\$210 / (3.00 \text{ A\$/US\$}) = \text{US\$}70$
Net asset	$= \text{US\$}440$

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. APJ's net asset position will result in a cumulative transaction adjustment loss as the foreign currency, the A\$, is depreciating.

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

(Module 10.4, LOS 10.d)

Related Material

[SchweserNotes - Book 2](#)

69. (A) remeasurement loss.

Explanation

APJ has a net monetary asset exposure:

Total monetary assets: $\text{Cash} + \text{A/R } A\$771 / (3.00 \text{ A\$/US\$}) = \text{US\$}257$

Total monetary liabilities: $A\$210 / (3.00 \text{ A\$/US\$}) = \text{US\$}70$

Net monetary asset = $\text{US\$}187$

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	
	Appreciating	Depreciating
Temporal method:	Appreciating	Depreciating
Net monetary assets	Gain	Loss
Net monetary liabilities	Loss	Gain

(Module 10.4, LOS 10.d)

Related Material

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70. (A) Sales will increase by 7.5%.

Explanation

The increase in sales due to the appreciating EUR is measured as 7.5% [= $(1.1417 / 1.0620) - 1$]. Sales for the subsidiary rose 10% [= $(1,100,000 / 1,000,000) - 1$] in the local currency (EUR). After translation the parent firm will report sales of USD 1,062,000 (= EUR 1,000,000 x 1.0620) for 2002 and USD 1,255,870 (= EUR 1,100,000 x 1.1417) for 2003.

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 $(1.10 \times 1.075) - 1 = 0.1825$. The question only asks for the impact of the change in the value of the USD.

(Module 10.2, LOS 10.c)

Related Material

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71. (B) acquisitions/divestitures and currency value fluctuations.

Explanation

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

(Module 10.8, LOS 10.i)

Related Material

[SchweserNotes - Book 2](#)

72. (B) The company shows a 12.5% growth 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.

(Module 10.2, LOS 10.c)

Related Material

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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. 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
December 31, 2012	130
2013 Average	140
2012 Average	120
Exchange rate on date that 2013 dividends were declared by Kasamatsu	145
Exchange rate on date of stock issue and acquisition of fixed assets.	100

Shelly 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, 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 other 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, 2013 (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, 2012	250,000
	369,000
Dividends	58,000
Retained Earnings: December 31, 2013*	311,000
*Retained earnings on 12/31/2013 were US \$2 million	

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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 stockholders' equity	786,000

73. (C) 145.

Explanation

Dividends are translated at the exchange rate that existed on the dividend declaration date.

(Module 10.4, LOS 10.d)

Related Material

[SchweserNotes - Book 2](#)

74. (A) 140.

Explanation

Under the current rate method, all items in the income statement would be translated at the average rate or 140JPY/USD. Because this question is asking only for translating sales, the average rate would be used even under the temporal method.

(Module 10.4, LOS 10.d)

Related Material

[SchweserNotes - Book 2](#)

75. (B) \$5,000.

Explanation

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

Because sales as a financial item is on the income statement, the 2013 average exchange rate of 140 JPY/USD must be used to calculate sales in the reporting currency. Kasamatsu's sales were JPY 700,000. The calculation is:

$$\frac{700,000\text{¥}}{140\text{Y} / \$} = \$5,000$$

WB will report \$5,000 of sales as a result of Kasamatsu's operations.

(Module 10.4, LOS 10.d)

Related Material

[SchweserNotes - Book 2](#)

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76. (C) **current rate method because the functional currency is the yen.**

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.

Under US GAAP the current rate method must be used to translate Kasamatsu's 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.

(Module 10.4, LOS 10.d)

Related Material

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77. (B) **A plant purchased several years ago.**

Explanation

The accounts receivable and dividends payable will each have book values that are closer to their market values than a plant purchased many years ago.

(Module 10.7, LOS 10.g)

Related Material

[SchweserNotes - Book 2](#)

78. (A) **GIC Europe's data should be translated under the current rate method; GIC China 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. dollars.**

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.

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 Bahamas' data should be remeasured under the temporal method into U.S. dollars.

(Module 10.4, LOS 10.e)

Related Material

[SchweserNotes - Book 2](#)

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79. (A) There will be no effect on the ratio.**Explanation**

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.

(Module 10.6, LOS 10.f)

Related Material

[SchweserNotes - Book 2](#)

80. (A) current rate method applies the current exchange rate to all balance sheet accounts.**Explanation**

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.

(Module 10.4, LOS 10.e)

Related Material

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81. (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 not differ from those calculated under the temporal method.

(Module 10.6, LOS 10.f)

Related Material

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82. (B) 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 $\$9,187,799 - \$8,562,133 = CAD 625,666$.

(Module 10.2, LOS 10.c)

Related Material

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