Chapter 8 – Advanced Accounting, 1st edition by Hamlen, Huefner, and Largay

Solutions to Practice Quiz

1. Topic: Translation gains and losses
   LO 1
   A U.S. company has a subsidiary in the U.K. Regardless of its functional currency, when converting the subsidiary's accounts to U.S. dollars, exposure to translation gains or losses is defined as the subsidiary's:

   a. Net assets
   b. Net assets translated at the end-of-year rate
   c. Assets reported at fair value
   d. Liabilities

   ANS: b
   Rationale: All accounts translated at the current rate change in U.S. dollar value over time, creating translation gains and losses.

Use the following information to answer questions 2 – 6 below:

A U.S. company acquired a subsidiary in the U.K at the beginning of the year. The subsidiary's beginning and ending trial balances, in pounds, are as follows:

	Beginning balances Dr (Cr)	**Ending balances Dr (Cr)**
Cash, receivables	£ 100,000	£ 1,300,000
Noncurrent assets, net	6,500,000	5,800,000
Liabilities	(4,000,000)	(4,200,000)
Capital stock	(600,000)	(600,000)
Retained earnings, beginning	(2,000,000)	(2,000,000)
Revenues		(4,000,000)
Out-of-pocket-operating expenses		3,000,000
Depreciation, amortization		700,000

Revenues and out-of-pocket expenses were incurred evenly over the year. Noncurrent assets are carried at amortized cost, and no new noncurrent assets were acquired. Exchange rates (U.S. dollars/£) are:

Beginning of year	$1.40
Average for the year	1.42
End of year	1.45

2. Topic: Translation of assets
LO 2, 3
Using the current rate method of translation, the subsidiary's end-of-year total assets are:

a. $10,005,000
b. $10,295,000
c. $ 9,940,000
d. $10,082,000

ANS: b
Rationale: All assets are translated at the current rate.
(£1,300,000 + £5,800,000) x $1.45 = $10,295,000

3. Topic: Remeasurement of assets
LO 2, 3
Using the temporal method of remeasurement, the subsidiary's end-of-year total assets are:

a. $10,005,000
b. $10,295,000
c. $ 9,940,000
d. $10,082,000

ANS: a
Rationale: Cash and receivables are translated at the current rate. Noncurrent assets are translated at the rate when acquired.
(£1,300,000 x $1.45) + (£5,800,000 x $1.40) = $10,005,000

4. Topic: Translation gain or loss
LO 2, 3
Using the current rate method of translation, the translation gain or loss for the year is:

a. $126,000 gain
b. $142,000 loss
c. $139,000 gain
d. $165,000 loss

ANS: c
Rationale: Exposure is defined as the subsidiary's net asset position.

Beginning exposure	£2,600,000 x $1.40	$3,640,000
+ Net income	300,000 x 1.42	426,000
		4,066,000
Ending exposure	£2,900,000 x 1.45	(4,205,000)
Translation gain		$ (139,000)

5. Topic: Remeasurement gain or loss
LO 2, 3
Using the temporal method of translation, the remeasurement gain or loss for the year is:

a. $126,000 gain
b. $142,000 loss
c. $139,000 gain
d. $165,000 loss

ANS: d
Rationale: Exposure is defined as the subsidiary's net assets reported at fair value.

Beginning exposure	£(3,900,000) x $1.40	$(5,460,000)
+ Revenues	4,000,000 x 1.42	5,680,000
Out-of-pocket expenses	(3,000,000) x 1.42	(4,260,000)
		(4,040,000)
Ending exposure	£(2,900,000) x 1.45	(4,205,000)
Remeasurement loss		$ 165,000

6. Topic: Remeasurement and translation of liabilities
LO 2, 3
The subsidiary's U.S. dollar ending liabilities, using remeasurement (temporal method) and translation (current rate method), are:

	Remeasurement	**Translation**
a.	$6,090,000	$6,090,000
b.	$6,090,000	$5,964,000
c.	$5,964,000	$6,090,000
d.	$5,964,000	$5,964,000

ANS: a
Rationale: Both translation and remeasurement use the current rate to convert liabilities to U.S. dollars. £4,200,000 x $1.45 = $6,090,000

7. Topic: Effect of changing exchange rates on financial analysis
LO 4
An Italian subsidiary's return on investment (ROA) is calculated as income before remeasurement gain or loss, divided by ending total assets. The U.S. dollar has been steadily strengthening with respect to the euro. How does the subsidiary's ROA in euros compare with its ROA remeasured using the temporal method and its ROA translated using the current rate method?

a. Euro > Current rate > Temporal
b. Current rate > Temporal > Euro
c. Euro > Temporal > Current rate
d. Current rate > Euro > Temporal

ANS: d
Rationale: Historical rates > Average rate > Ending rate.
The current rate method translates the numerator using the average rate and the denominator using the ending rate; the result is greater than the euro ROA.
The temporal method translates the numerator using the average rate for revenues and a mix of average and historical rates for expenses. The denominator is translated using a mix of average and historical rates. The result is less than the euro ROA.

8. Topic: Hedges of net investments
LO 5
A U.S. company has a subsidiary in Germany. The subsidiary's functional currency is the euro, and the U.S. dollar has steadily strengthened with respect to the euro. How does an effective hedge of the net investment in the subsidiary affect the consolidated financial statements?

a. Reduces the remeasurement loss reported on the income statement
b. Reduces the remeasurement gain reported on the income statement
c. Reduces the translation loss reported in other comprehensive income on the balance sheet
d. Reduces the translation gain reported in other comprehensive income on the balance sheet

ANS: c
Rationale: When the subsidiary's functional currency is its local currency, translation gains and losses are reported in other comprehensive income. When the U.S. dollar strengthens, the U.S. dollar value of net assets declines, causing a translation loss. A hedge investment reduces that loss.

9. Topic: Hedges of net investments
LO 5
A U.S. company has a subsidiary in Germany. The subsidiary's functional currency is the euro, and it has positive net assets. Which of the following investments is an effective hedge of the company's net investment in the subsidiary?

a. Notes receivable denominated in euros
b. Put option in euros
c. Investments in euro-denominated securities
d. Forward purchase of euros

ANS: b
Rationale: Exposure is a net asset position. Neutralize the risk by taking an opposite position (liability denominated in euros) or by locking in the selling price of the euro, with a forward sale or put option in euros.

10. Topic: IFRS and U.S. GAAP in hyperinflationary economies
LO 3, 7
An Italian parent owns a subsidiary in Venezuela. The subsidiary's functional currency is the local currency, the bolivar. The parent has determined that Venezuela is a hyperinflationary country. The subsidiary holds land costing 1,000,000 bolivar, acquired after the parent acquired the subsidiary, when the general price index was 200 and the exchange rate was €1.50/bolivar. At the end of the current year, the general price index is 1200 and the exchange rate is €0.20/bolivar. IFRS and U.S. GAAP conversion of the subsidiary's land to euros is:

	IFRS	**U.S. GAAP**
a.	€1,200,000	€1,500,000
b.	€1,500,000	€1,200,000
c.	€1,200,000	€1,200,000
d.	€1,500,000	€1,500,000

ANS: a
Rationale:
IFRS: (1200/200) x 1,000,000 = 6,000,000 x €0.20 = €1,200,000
U.S. GAAP: 1,000,000 x €1.50 = €1,500,000