Global Perspectives on Accounting Education
Volume 14, 2017, 1-9

FOREIGN CURRENCY TRANSLATION AND CONSOLIDATION: A CASE STUDY

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ABSTRACT

In 2014, Ferguson Pumps Inc. (Ferguson) opened a facility (Le Pumps) in Europe, which builds and sells pumps throughout Europe. Ferguson sold inventory to Le Pumps; some of which remain in Le Pumps' inventory at year-end. Ferguson Pumps capitalized Le Pumps and also lent Le Pumps money on both short-term and long-term bases. This case is structured in a multinational operating environment and requires students to: determine Le Pumps' functional currency, translate financial statements into the U.S. Dollar, prepare all eliminating entries and intercompany adjustments along with consolidated statements, forgive debt, and list authoritative guidance under U.S. GAAP for

all requirements. Key issues include foreign currency translation and transaction gains/losses, consolidation, and intercompany transactions.

Keywords: foreign currency translation, foreign currency transaction gains/losses, consolidation, intercompany transactions, eliminating entries, intercompany adjustments

INTRODUCTION

This case is structured in a multinational operating environment and requires students to: (1) determine the functional currency; (2) translate foreign denominated financial statements into United States (U.S.) Dollars, (3) prepare a consolidated income statement, balance sheet, and cash flow statement along with eliminating entries and intercompany adjustments, (4) determine how to record debt forgiveness, and (5) list authoritative guidance under U.S. GAAP for all requirements. In addition to providing skills directly related to the case requirements (e.g. research and translation practice), this case, depending upon implementation, could help students improve other skills such as problem solving, communication, professional demeanor, and leveraging technology. These are all components of the AICPA Core Competencies.[1]

THE CASE

Ferguson Pumps, Inc. (Ferguson), a firm domiciled in the U.S., manufactures and distributes submersible pumps throughout the U.S. and Europe. Ferguson has been experiencing strong growth in Europe, but it has been limited due to the long lead times required to build and supply the submersible pumps from the U.S. In order to further grow the European market, Ferguson felt it was necessary to open a manufacturing facility in Manchester, England. The wholly-owned subsidiary will carry the name of Le Pumps, Ltd (Le Pumps) and was formed on January 1, 2014. Ferguson's plan is to have Le Pumps produce the majority of the submersible pumps that are being sold to companies located in Europe; however, certain specialty pumps will still be produced and shipped from the U.S.

On January 1, 2014, Ferguson capitalized Le Pumps with a cash inflow of $1,000,000. Furthermore, to assist Le Pumps in funding its start-up expenses and purchase equipment necessary for operations, Ferguson made the following loans to Le Pumps:[2]

January 31, 2014	$6,000,000
March 31, 2014	$2,000,000
June 30, 2014	$1,000,000

Ferguson expects Le Pumps to repay the March and June loans within the next 12 months and believes the January loan will not be repaid in the foreseeable future.

[1]http://www.aicpa.org/interestareas/accountingeducation/resources/pages/corecompetency.aspx
[2] Related transactions gains/losses, if any, do not appear in the provided financial statements.

Le Pumps was fully operational and building pumps by March 31, 2014 and began shipping pumps in April 2014. All of Le Pumps' transactions are denominated in British pounds (a.k.a. Pound Sterling) except for intercompany sales and loans, which are denominated in the U.S. Dollar.

Ferguson designed a new line of pumps in late 2013 for which Le Pumps currently doesn't have the tooling. Therefore, Le Pumps is purchasing these pumps from Ferguson for distribution throughout Europe. During the year ended December 31, 2014, Ferguson sold Le Pumps $4,000,000 (Ferguson's selling price) of pumps and $500,000 of these pumps remain in Le Pumps' inventory at year-end. Ferguson realizes a 20% gross margin on all pumps its sells to Le Pumps. All intercompany sales were settled between Ferguson and Le Pumps by December 31, 2014. That is, all pumps purchased by Le Pumps have been delivered and paid upon delivery by December 31, 2014.

During the year ended December 31, 2014, Le Pumps purchased all of their equipment using the initial capital inflow and intercompany loans from Ferguson. There were no disposals of fixed assets by either Ferguson or Le Pumps during the year ended December 31, 2014.

To facilitate short-term borrowing needs, Le Pumps opened a line of credit with a local bank in Manchester, England. Maximum borrowings on the line of credit are £4,000,000 and are to be collateralized by Le Pumps' accounts receivable and inventory.

For simplicity purposes, assume all intercompany transactions and elimination entries are on a tax free basis (i.e. please do not tax effect these entries).

The following financial statements are attached to assist in completing the case study:

- Balance sheets for Ferguson as of December 31, 2014 and December 31, 2013 on a stand-alone basis.
- Income statements for Ferguson for the years ended December 31, 2014 and 2013 on a stand-alone basis.
- Balance sheet for Le Pumps as of December 31, 2014 on a stand-alone basis and before intercompany adjustments and the forgiveness of the intercompany loan noted below.
- Income statement for Le Pumps for the year ended December 31, 2014 on a stand-alone basis and before intercompany adjustments.

Figure 1

Ferguson Pumps, Inc.
Balance Sheets
December 31, 2014 and 2013

	12/31/2014	12/31/2013
Current Assets		
Cash	$500,000	$750,000
Accounts receivable	15,000,000	13,500,000
Inventory	13,500,000	11,000,000
Due from subsidiary	3,000,000	0
Prepaid expenses	600,000	750,000
Total current assets	32,600,000	26,000,000
Property and Equipment		
Machinery and equipment	22,000,000	20,000,000
Computer Equipment	2,000,000	1,750,000
Furniture and Fixtures	1,500,000	1,500,000
	25,500,000	23,250,000
Less accumulated depreciation	13,400,000	10,900,000
	12,100,000	12,350,000
Investment in subsidiary	1,000,000	0
Due from subsidiary	6,000,000	0
	7,000,000	0
	$51,700,000	$38,350,000
Current Liabilities		
Line of credit, bank	$15,000,000	$10,000,000
Accounts payable	14,000,000	12,000,000
Accrued expenses	3,500,000	4,980,000
Total current liabilities	32,500,000	26,980,000
Stockholders' Equity		
Common stock	1,000	1,000
Additional paid in capital	1,500,000	1,500,000
Retained earnings	17,699,000	9,869,000
	19,200,000	11,370,000
	$51,700,000	$38,350,000

Figure 2

Ferguson Pumps, Inc.
Income Statements
For the Years Ended December 31, 2014 and 2013

	12/31/2014	12/31/2013
Net Sales	$120,000,000	- $125,000,000
Cost of Goods Sold	72,000,000	75,000,000
Gross Profit	48,000,000	50,000,000
Selling, general and administrative expenses	34,250,000	36,000,000
Operating income	13,750,000	14,000,000
Other income (expense):		
Interest income	100,000	75,000
Interest expense	(800,000)	(600,000)
	(700,000)	(525,000)
Income before income taxes	13,050,000	13,475,000
Income taxes	5,220,000	5,390,000
Net income	$7,830,000	$8,085,000

Figure 3

Le Pumps, Ltd.
Balance Sheet
December 31, 2014
(In Pounds Sterling)

Current Assets			
	Cash	£	2,000,000
	Accounts receivable		3,500,000
	Inventory		4,500,000
	Prepaid expenses		200,000
	Total current assets		10,200,000
Property and Equipment			
	Machinery and equipment		6,000,000
	Computer Equipment		500,000
	Furniture and Fixtures		200,000
			6,700,000
	Less accumulated depreciation	838,710	
			5,861,290
Deposits			350,000
		£	16,411,290
Current Liabilities			
	Line of credit, bank	£	2,000,000
	Due to parent		1,924,752
	Accounts payable		5,000,000
	Accrued expenses		750,000
	Total current liabilities		9,674,752
Long-term liabilities, due to parent			3,647,436
Stockholders' Equity			
	Common stock	£	747,272
	Retained earnings		2,341,830
			3,089,102
		£	16,411,290

Figure 4

Le Pumps, Ltd.
Income Statement
For the Year Ended December 31, 2014
(In Pounds Sterling)

Net Sales	£ 21,000,000
Cost of Goods Sold	14,100,000
Gross Profit	6,900,000
Selling, general and administrative expenses	2,976,950
Operating income	3,923,050
Other income (expense):	
Interest income	50,000
Interest expense	(70,000)
	(20,000)
Income before income taxes	3,903,050
Income taxes	1,561,220
Net income	£ 2,341,830

CASE QUESTIONS

1. What is the functional currency of Le Pumps, Ltd.? Please provide rationale, including the appropriate support (U.S. GAAP authoritative guidance) regarding the currency chosen.
2. Please prepare a consolidated balance sheet, income statement and statement of cash flows (indirect method) for Ferguson Pumps, Inc. and subsidiary as of and for the year ending December 31, 2014. Please provide support (U.S. GAAP authoritative guidance) for any eliminating entries and/or intercompany adjustments. Hint: Be sure to examine both transaction and translation gains and losses[3,4]
3. Please list the authoritative guidance under U.S. GAAP for this consolidation (may be included with requirement 2).
4. Assuming that Ferguson reports on a quarterly basis and also assuming that due to certain rules within England (United Kingdom) regarding capitalization of a foreign owned subsidiary, on December 15, 2014, Ferguson forgave $2,500,000 of the $6,000,000 January 31, 2014 intercompany loan. What would be your journal entry to record this transaction? Be sure to provide calculations (if any) supporting your entry.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the "For Contributors" page of the journal website, http://gpae.wcu.edu.

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[3] Exchange rates may be obtained from X-Rates (www.x-rates.com) or OANDA (www.oanda.com). Be sure to use the entire rate given (e.g. 6 decimals for x-rate) and when calculating dollar amounts, avoid rounding until you reach the final number to be used in the financial statement.

[4] One method to complete this task would be to: (1) calculate transaction gains/losses (if any) to be posted to the subsidiaries account using the foreign currency; (2) prepare intercompany eliminating entries (if any) in U.S. Dollars, (3) translate the foreign subsidiary into U.S. Dollars; (4) combine the two/multiple entities now in U.S. Dollars, and (5) post the required eliminating entries (from step 2 above) in U.S. Dollars.

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