Statement of Financial Accounting Standards No. 20

Note: This Statement has been completely superseded

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FAS20 Summary

Accounting for Forward Exchange Contracts

an amendment of FASB Statement No. 8

December 1977

Financial Accounting Standards Board
of the Financial Accounting Foundation
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INTRODUCTION AND BACKGROUND INFORMATION

1. Paragraph 27 of *FASB Statement No. 8,* "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," specifies conditions that must be met to defer a gain or loss on a forward exchange contract (*forward contract*). Paragraph 27 states that:

> . . .a forward contract shall be considered a hedge of an identifiable foreign currency commitment..., provided *all* of the following conditions are met:
>
> a. The life of the forward contract extends from the foreign currency commitment date to the anticipated transaction date...or a later date....
> b. The forward contract is denominated in the same currency as the foreign currency commitment and for an amount that is the same or or less than the amount of the foreign currency commitment.
> c. The foreign currency commitment is firm and uncancelable.

With respect to the application of those conditions, the FASB has been asked:

a. Whether an enterprise may defer a gain or loss on a forward contract that is intended to hedge a commitment that was entered into before the effective date of FASB Statement No. 8 [1] even though the life of the forward contract does not extend from the commitment date.
b. Whether an enterprise may defer a gain or loss on a portion of a forward contract in excess of the related commitment to the extent that the forward contract is intended to provide a hedge of the commitment on an after-tax basis, i.e., to assure that the gain or loss on the forward contract offsets the effects of an exchange rate change on the foreign currency exposure related to the commitment, after considering the net related tax effects.

Hedging a Commitment Entered into before FASB Statement No. 8 Became Effective

2. By specifying that the life of a forward contract must extend from the foreign currency commitment date, paragraph 27(a) of *FASB Statement No. 8* would appear to preclude the deferral of a gain or loss on any forward contract entered into after the commitment date. However, that was not the intent of the Board if a forward contract is intended to hedge a commitment entered into before the effective date of Statement No. 8. Accordingly, the Board is specifying a transition period during which an enterprise may enter into a forward contract to hedge an existing commitment that was entered into before the effective date of Statement No. 8. For purposes of determining compliance with the conditions for deferral of a gain or loss, such a forward contract will be considered to have met the condition of paragraph 27(a) even though its life does not extend from the foreign currency commitment date.

Hedging on an After-Tax Basis

3. Paragraph 24 of *FASB Statement No. 8* states, "a gain or loss shall be deferred and included in the measurement of the dollar basis of the related foreign currency transaction if the gain or loss pertains to a forward contract that is intended to be a hedge of an identifiable foreign currency commitment that meets the conditions described in paragraph 27." The reason for that requirement is explained in paragraphs 207 and 208 of Statement No. 8.

4. Paragraph 27 of *FASB Statement No. 8* limits the deferral of a gain or loss on a forward contract to the gain or loss pertaining to the portion of the forward contract that is not in excess of the related commitment. Thus, any gain or loss pertaining to a portion of a forward contract in excess of the related commitment is included in the determination of net income currently. After consideration of the question of hedging on an after-tax basis, the Board has decided that paragraph 27 of Statement No. 8 should be amended to require the deferral of a gain or loss on a portion of a forward contract *in excess of the related commitment* if certain conditions have been met. Those conditions are specified in paragraph 10 of this Statement.

5. An Exposure Draft of a proposed Statement on "Accounting for Forward Exchange Contracts" was issued on November 7, 1977. The Board received 30 letters of comment in response to the Exposure Draft, virtually all of which expressed agreement.

6. Some respondents recommended that the final Statement should include other amendments of *FASB Statement No. 8* in addition to the provisions in the Exposure Draft, including an amendment to permit the gain or loss pertaining to a hedge of a net monetary position on an after-tax basis to be determined by the method specified in paragraph 25 of Statement No. 8. The Board concluded that consideration of other possible amendments of Statement No. 8 should not delay the issuance of this Statement and noted that the determination of the gain or loss pertaining to a hedge of a net monetary position on an after-tax basis by the method specified in paragraph 25 is not now precluded by Statement No. 8.

7. Some respondents questioned whether the requirement of the Exposure Draft to include the gain or loss pertaining to the portion of a forward contract that is intended to provide a hedge on an after-tax basis as an offset to the related tax effects is contrary to *APB Opinion No. 11,* "Accounting for Income Taxes." The Board concluded that such a requirement is not contrary to Opinion No. 11 and does not modify the disclosure requirements of paragraph 60 of that Opinion. However, the Board concluded that tax effects related to a hedge of a net monetary position should not be offset. The Board believes that with respect to a hedge of a commitment the requirement to offset a gain or loss against the related tax effects is consistent with paragraph 24 of *FASB Statement No. 8,* which requires a deferred gain or loss pertaining to a forward contract that is intended to hedge an identifiable commitment to be included as an adjustment of the dollar basis of the foreign currency transaction. Further, the Board believes that with respect to a hedge of a net monetary position the requirement not to offset the related tax effects is consistent with the conclusion in paragraph 212 of Statement No. 8, which views such forward contracts as independent transactions.

8. The Board has concluded that on the basis of existing data it can reach an informed decision without a public hearing and that the effective date and transition specified in paragraphs 14 and 15 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

9. For purposes of applying paragraph 27 of *FASB Statement No. 8,* a forward contract that is intended to hedge an identifiable foreign currency commitment entered into before the effective date of Statement No. 8 shall be deemed to have met the conditions specified in paragraph 27(a) of Statement No. 8 if the life of the forward contract extends from a date prior to March 31, 1978 to the anticipated transaction date [2] or a later date.[3]

10. If the conditions of paragraph 27 of FASB Statement No. 8 as amended are met, a gain or loss pertaining to a portion of a forward contract in excess of the related commitment shall be deferred to the extent that the forward contract is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized.[4] A gain or loss that has been offset against related tax effects shall not be included in the aggregate exchange gain or loss disclosure required by paragraph 32 of Statement No. 8.

11. A gain or loss pertaining to the portion of a forward contract in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred.

Amendments to FASB Statement No. 8

12. Paragraph 35 of *FASB Statement No. 8* is amended to add the following as the last sentence:

> For purposes of applying the provisions of paragraph 27(a) of this Statement, *FASB Statement No. 20* provides a limited exception for forward contracts that are intended to hedge commitments entered into before the provisions of this Statement are initially applied.

13. The words "and for an amount that is the same or less than the amount of the foreign currency commitment" in paragraph 27(b) of *FASB Statement No. 8* are deleted. The last two sentences of paragraph 27 of Statement No. 8 are superseded by the following:

> The portion of a forward contract that shall be accounted for pursuant to paragraph 24 is limited to the amount of the related commitment. If a forward contract that meets conditions (a) through (c) above exceeds the amount of the related commitment, the gain or loss pertaining to a portion of the forward contract in excess of the commitment shall be deferred to the extent that the forward contract is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized. A gain or loss that has been offset against related tax effects shall not be included in the aggregate exchange gain or loss disclosure required by paragraph 32. A gain or loss pertaining to the portion of a forward contract in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred.

Effective Date and Transition

14. This Statement shall be effective prospectively beginning January 1, 1978. Earlier application is encouraged in financial statements for annual and interim periods ending before January 1, 1978 that have not been previously issued. Previously issued annual or interim financial statements shall not be restated to comply with the provisions of this Statement.

15. An enterprise that has hedged a foreign currency commitment with a forward contract that meets the conditions of paragraph 27 of *FASB Statement No. 8* as amended, and, prior to March 31, 1978, has entered into a forward contract for an amount in excess of the related commitment shall defer the gain or loss on the amount of the excess that is intended to provide a hedge on an after-tax basis. Any gain or loss with respect to such excess that has been previously recognized in the determination of net income shall not be restated.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board.

Marshall S. Armstrong, *Chairman*
Oscar S. Gellein
Donald J. Kirk
Arthur L. Litke
Robert E. Mays
Robert T. Sprouse
Ralph E. Walters

Appendix A: EXAMPLE OF APPLICATION OF THIS STATEMENT

16. The following example, paragraphs 17-20, provides guidance for applying paragraphs 10 and 11 of this Statement.

General Assumptions

17. Assume the following:

a. ABC Company and XYZ Company, a wholly owned foreign subsidiary of ABC Company, both have fiscal years ending December 31.
b. On November 1, 1978, when the exchange rate is FC1 = $1, XYZ Company enters into a commitment to sell for FC2,120,000 on March 1, 1979 certain previously acquired and paid for assets having a cost of FC1,720,000 ($1,720,000).
c. Foreign income is subject to foreign taxes at the rate of 10 percent.
d. U.S. income is subject to U.S. taxes at the rate of 48 percent.
e. XYZ Company will invest its undistributed earnings indefinitely. Accordingly, under the provisions of *APB Opinion No. 23,* "Accounting for Income Taxes—Special Areas," no U.S. income taxes are provided on XYZ Company's undistributed earnings in ABC Company's consolidated financial statements.
f. The forward rate is FC1 = $1. (This example assumes that there is no premium or discount.)

18. Given the above assumptions, if the exchange rate does not change, ABC Company's reportable pre-tax profit in dollars from the transaction is $400,000 [$2,120,000 (FC2,120,000 x $1) selling price less $1,720,000 cost] and reportable after-tax profit in dollars is $360,000 [$400,000 pre-tax profit less $40,000 (FC40,000 X $1) foreign taxes].

19. Assume the same information as given in paragraph 17 and that the exchange rate changes on December 31, 1978 to FC1 = $.90 and that it remains unchanged through March 1, 1979. In this case, ABC Company's reportable pre-tax profit in dollars from the transaction is $188,000 [$1,908,000 (FC2,120,000 x $.90) selling price less $1,720,000 cost] and reportable after-tax profit is $152,000 [$188,000 pre-tax profit less $36,000 (FC40,000 x $.90) foreign taxes].

20. Assume further that on November 1, 1978 ABC Company entered into a forward contract to sell forward FC5,000,000 for delivery on March 1, 1979 to hedge XYZ Company's commitment on an after-tax basis and to hedge a specific exposed monetary item of FC1,000,000 of ABC Company. The amount of a forward contract necessary to hedge the sales commitment in full on an after-tax basis is FC4,000,000, computed by dividing the net foreign currency exposure of FC2,080,000 by 52 percent (the complement of the U.S. income tax rate of 48 percent). In other words, a forward contract of FC4,000,000 assures that the effects of any exchange rate change on the foreign currency exposure related to the commitment will be offset by the gain or loss on the forward contract, after considering the net related tax effects. Accordingly, pursuant to paragraph 11 of this Statement, ABC Company cannot defer any gain or loss pertaining to the portion of the forward contract in excess of FC4,000,000. Given the above assumptions, an exchange rate change to FC1 = $.90 on December 31, 1978 results in the following:

Gain on forward contract (determined by the method specified in paragraph 25 of Statement No. 8):

Total forward contract	FC5,000,000
Exchange rate change	× ($1 – $.90)
Gain on forward contract	$ 500,000

Portion of gain deferrable as a hedge of foreign currency sales commitment:

Forward contract	FC2,120,000
Exchange rate change	× ($1 – $.90)
Gain deferrable as a hedge of foreign currency sales commitment	$ 212,000

Portion of gain deferrable as a hedge of the net related tax effects (pursuant to paragraph 10 of this Statement):

Forward contract	FC1,880,000
Exchange rate change	× ($1 – $.90)
Gain deferrable as hedge of net related tax effects	$ 188,000

Portion of gain to be recognized in period in which exchange rate changes (pursuant to paragraph 11 of this Statement):

Forward contract	FC1,000,000

Exchange rate change	× ($1 – $.90)
Gain to be recognized in period in which exchange rate changes	$ 100,000

Calculation of net related tax effects:

Amount of forward contract intended to hedge the sales commitment on an after-tax basis	FC4,000,000
Exchange rate change	× ($1 – $.90)
Gain on forward contract	$ 400,000
U.S. income tax rate	48%
U.S. income taxes attributable to the gain on the forward contract	192,000
Reduction of foreign taxes in dollars resulting from exchange rate change (see below)	4,000
Net related tax effects	$ 188,000

Calculation of reduction of foreign taxes in dollars resulting from exchange rate change:

Selling price	FC2,120,000
Cost	1,720,000
Pre-tax profit	FC 400,000
Foreign tax rate	10%
Foreign taxes	FC 40,000
Exchange rate change	× ($1 – $.90)
Reduction of foreign taxes in dollars resulting from exchange rate change	$ 4,000

If the exchange rate remains at FC1 = $.90 through March 1, 1979, pursuant to paragraph 24 of *FASB Statement No. 8,* the deferred gain of $212,000 would be included in the measurement of the dollar basis of the selling price of the assets on March 1, 1979. Also, pursuant to paragraph 10 of this Statement, the deferred gain of $188,000 would be included as an offset to the related tax effects in the period in which such tax effects are recognized.

Footnotes

FAS20, Footnote 1--For purposes of this Statement, the effective date of Statement No. 8 means the date that an enterprise first applied the provisions of Statement No. 8.

FAS20, Footnote 2--See footnote 9 of Statement No. 8.

FAS20, Footnote 3--See footnote 10 of Statement No. 8.

FAS20, Footnote 4--The requirement to offset such gains or losses against the related tax effects does not modify the disclosure requirements of paragraph 60 of *APB Opinion No. 11.*