FASB Interpretation No. 17

Note: This Interpretation has been completely superseded

FIN17 Status Page

Applying the Lower of Cost or Market Rule in Translated Financial Statements

an interpretation of FASB Statement No. 8

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Financial Accounting Standards Board
of the Financial Accounting Foundation
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FIN 17: Applying the Lower of Cost or Market Rule in Translated Financial Statements

an interpretation of FASB Statement No. 8

INTRODUCTION

1. The FASB has been asked to clarify the determination of *market* when applying the rule of *cost or market, whichever is lower*, in translated financial statements. The FASB also has been requested to clarify the manner of reporting a write-down of inventory resulting from application of that rule in the translated financial statements.

2. *FASB Statement No. 8*, "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," relies on existing U.S. generally accepted accounting principles which for purposes of pricing inventories are set forth in Chapter 4, "Inventory Pricing," of *ARB No. 43*. Chapter 4 specifies that inventory should be stated at *cost or market, whichever is lower*. To ensure that inventory in the translated statements conforms to that rule, paragraph 14 of Statement No. 8 requires that the rule of *cost or market, whichever is lower*, be applied *in dollars*.[1]

3. Appendix A of *FASB Statement No. 8* explains and illustrates now to apply the rule of *cost or market, whichever is lower*, in translated financial statements. Paragraph 46 of Statement No. 8 states that "to apply the rule of *cost or market, whichever is lower* (as described in Statement 6 of Chapter 4, 'Inventory Pricing,' of ARB No. 43), *translated historical cost* shall be compared with *translated market*."

4. Statement 6 of Chapter 4 of ARB No. 43 is as follows:

> As used in the phrase *lower of cost or market*. . . the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> (1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Although the above is referred to as the rule of *cost or market*, *whichever is lower*, the discussion of Statement 6 in Chapter 4 of *ARB No. 43* states that "because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule."

INTERPRETATION

5. Because *FASB Statement No. 8* relies on U.S. generally accepted accounting principles, *translated market* for inventory shall be determined in accordance with the provisions of Chapter 4 of *ARB No. 43*. When applying the literal rule of *cost or market, whichever is lower*, in translated financial statements, *translated market* shall be current foreign currency replacement cost translated at the current rate,[2] except that:

a. *Translated market* shall not exceed foreign currency net realizable value translated at the current rate;[3] and
b. *Translated market* shall not be less than foreign currency net realizable value reduced by an allowance for an approximately normal profit margin translated at the current rate.[4]

6. Literal application of the rule of *cost or market, whichever is lower*, will require an inventory write-down [5] in dollar financial statements for locally acquired inventory [6] if the value of the foreign currency has declined in relation to the dollar between the date the foreign operation acquired its inventory and the date of the foreign operation's balance sheet unless foreign currency replacement costs or selling prices have increased sufficiently so that translated market measured in dollars exceeds translated historical cost. Paragraphs 7-9 illustrate literal application of the rule *in dollars*.

7. Assume the following:

a. When the rate is FC 1 = $2.40, a foreign subsidiary of a U.S. company purchases a unit of inventory at a cost of FC 500 (measured in dollars, $1,200),
b. At the foreign subsidiary's balance sheet date, the current rate is FC 1 = $2.00 and the current replacement cost of the unit of inventory is FC 560 (measured in dollars, $1,120),
c. Net realizable value is FC 630 (measured in dollars, $1,260),
d. Net realizable value reduced by an allowance for an approximately normal profit margin is FC 550 (measured in dollars, $1,100).

Because current replacement cost measured in dollars ($1,120) is less than translated historical cost ($1,200), an inventory write-down of $80 is required in the dollar financial statements.

8. Assume the same information as given in the preceding example except that current replacement cost at the foreign subsidiary's balance sheet date is FC 620. Because market measured in dollars (FC 620 × \$2.00 = \$1,240) exceeds translated historical cost (FC 500 × \$2.40 = \$1,200), an inventory write-down is not required in the dollar financial statements.

9. As a further example, assume the same information given in paragraph 7 except that foreign currency selling prices have increased so that net realizable value is FC 720, and net realizable value reduced by an allowance for an approximately normal profit margin is FC 640. In this case, because replacement cost measured in dollars (FC 560 × \$2.00 = \$1,120) is less than net realizable value reduced by an allowance for an approximately normal profit margin measured in dollars (FC 640 × \$2.00 = \$1,280), translated market is \$1,280. Because translated market (\$1,280) exceeds translated historical cost (FC 500 × \$2.40 = \$1,200), an inventory write-down is not required in the dollar financial statements.

10. Disclosure of inventory write-downs that result from applying the rule of *cost or market, whichever is lower*, is specified by *ARB No. 43*, Chapter 4, paragraph 14, as follows:

> When substantial and unusual losses result from the application of this rule it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separately identified from the consumed inventory costs described as *cost of goods sold*.

Paragraph 16 of Statement No. 8 specifies that "exchange gains or losses are a consequence of translation..."; that is, "they result from the procedures specified in paragraphs 7(b) and 11-13...." Inventory write-downs are a consequence of applying the rule of *cost or market, whichever is lower*, in translated financial statements as required by paragraph 14 of Statement No. 8 and, accordingly, are not exchange losses. Therefore, such inventory write-downs in translated financial statements shall *not* be included in the aggregate exchange gain or loss required to be disclosed pursuant to paragraph 32 of Statement No. 8, but shall be reported in accordance with paragraph 14 of Chapter 4 of *ARB No. 43* and, in addition, included in the disclosures made pursuant to paragraph 33 of Statement No. 8.

EFFECTIVE DATE AND TRANSITION

11. The provisions of this Interpretation shall be effective for financial statements for annual and interim periods ending after March 15, 1977. Earlier application is encouraged in financial statements for annual and interim periods ending before March 16, 1977 that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued annual or interim financial statements unless it is being applied concurrently with initial application of *FASB Statement No. 8*, in which case previously issued financial statements shall

be restated in accordance with either paragraph 35 or 36 of Statement No. 8.

This Interpretation was adopted by the unanimous vote of the six members of the Financial Accounting Standards Board following submission to the members of the Financial Accounting Standards Advisory Council.

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

Footnotes

FIN17, Footnote 1--For convenience, both *FASB Statement No. 8* and this Interpretation assume that the translated financial statements are prepared using the U.S. dollar (dollar) as the unit of measure. See footnote 1 to *FASB Statement No. 8*.

FIN17, Footnote 2--In the case of replacement by *reproduction*, certain elements of replacement cost (e.g., depreciation included in inventory) may need to be translated at historical rates to determine *translated market*.

FIN17, Footnote 3--See footnote 2 above.

FIN17, Footnote 4--In the case of replacement by *purchase*, if *normal profit margin* is viewed as being other than *gross profit margin*, translation entirely at the current rate may not be appropriate. In the case of replacement by *reproduction*, if *normal profit margin* is viewed as other than *gross profit margin*, certain elements, in addition to those referred to in footnote 2, may need to be translated at historical rates.

FIN17, Footnote 5--As to interim periods, paragraph 14(c) of APB Opinion No. 28, "Interim Financial Reporting," states:

Inventory losses from market declines should not be deferred beyond the interim period in which the decline occurs. Recoveries of such losses on the same inventory in later interim periods of the same fiscal year through market price recoveries should be recognized as gains in the later interim period. Such gains should not exceed previously recognized losses. Some market declines at interim dates, however, can reasonably be expected to be restored in the fiscal year. Such *temporary* market declines need not be recognized at the interim date since no loss is expected to be incurred in the fiscal year.

FIN17, Footnote 6--An inventory write-down may also be required for imported inventory.