CHAPTER 11
THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES (IAS-21)

Objective

The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

Scope

This Standard shall be applied:

(a) in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of IAS 39;

(b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and

(c) in translating an entity's results and financial position into a presentation currency.

This Standard does not apply to the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation.

Definitions

Closing Rate is the spot exchange rate at the end of the reporting period.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

Presentation currency is the currency in which the financial statements are presented.

Spot exchange rate is the exchange rate for immediate delivery.

Elaboration on the Definitions

Functional Currency

The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash.

An entity considers the following factors in determining its functional currency:

(a) the currency:

  (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

(ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labor, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

The following factors may also provide evidence of an entity's functional currency:

(a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.

(b) the currency in which receipts from operating activities are usually retained.

The following additional factors are considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity (the reporting entity, in this context, being the entity that has the foreign operation as its subsidiary, branch, associate or joint venture):

(a) Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

(b) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

(c) Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

When the above indicators are mixed and the functional currency is not obvious, management uses its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.

Basic Steps for Translating Foreign Currency Amounts into the Functional Currency

Steps apply to a stand-alone entity, an entity with foreign operations (such as a parent with foreign subsidiaries), or a foreign operation (such as a foreign subsidiary or branch).

1. The reporting entity determines its functional currency
2. The entity translates all foreign currency items into its functional currency
3. The entity reports the effects of such translation in accordance with this IAS.

Reporting Foreign Currency Transactions in the Functional Currency

Initial Recognition

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

(c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

Reporting at the end of subsequent reporting periods

a) Foreign currency monetary amounts should be reported using the closing rate.

b) Non-monetary items carried at historical cost should be reported using the exchange rate at the date of the transaction.

c) Non-monetary items carried at fair value should be reported at the rate that existed when the fair values were determined.

Recognition of exchange differences

Monetary items

Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognized or in previous financial statements are reported in profit or loss in the period, except the monetary items qualify as hedging instrument in cash flow hedge.

Non-monetary items

When a gain or loss on a non-monetary item is recognized in other comprehensive income, any exchange component of that gain or loss shall be recognized in other comprehensive income. Conversely, when a gain or loss on a non-monetary item is recognized in profit or loss, any exchange component of that gain or loss shall be recognized in profit or loss.

Exception

The exception is that exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognized, in the consolidated financial statements that include the foreign operation, in other comprehensive income; they will be reclassified from equity to profit or loss on disposal of the net investment.

Change in Functional Currency

When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.

USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

Translation to the Presentation Currency

An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency.

For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented.

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

(a) assets and liabilities for each balance sheet presented (i.e. including comparatives) shall be translated at the closing rate at the date of that statement of financial position;

(b) income and expenses for each statement of comprehensive income (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences shall be recognized in other comprehensive income.

For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example an average rate for the period, is often used to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

The exchange differences referred above:

(a) translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate. Such exchange differences arise both on income and expense items recognized in profit or loss and on those recognized directly in equity.

(b) translating the opening net assets at a closing rate that differs from the previous closing rate.

These exchange differences are recognized in other comprehensive income because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations. When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non controlling interests are allocated to, and recognized as part of, non controlling interest in the consolidated statement of financial position.

Translation of a Foreign Operation

a) The above paragraphs apply when the results and financial position of a foreign operation are translated into a presentation currency so that the foreign operation can be included in the financial statements of the reporting entity by consolidation, proportionate consolidation or the equity method.

b) The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of intragroup balances and intragroup transactions of a subsidiary. However, an intra-group monetary asset (or liability), whether short-term or long-term, cannot be eliminated against the corresponding intra-group liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference continues to be recognized in profit or loss or unless otherwise required.

c) When the financial statements of a foreign operation are as of a date different from that of the reporting entity, the foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements. When this is not done, IAS 27 allows the use of a different reporting date provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates. In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the statement of financial position date of the foreign operation. Adjustments are made for significant changes in exchange rates up to the statement of financial position date of the reporting entity in accordance with IAS 27. The same approach is used in applying the equity method to associates and joint ventures and in applying proportionate consolidation to joint ventures in accordance with IAS 28 Investments in Associates and IAS 31.

d) Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be treated as assets and liabilities of the foreign operation. Thus they shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate.

Disposal of a Foreign Operation

On the disposal of a foreign operation, the cumulative amount of the exchange differences recognized in other comprehensive income and accumulated the separate component of equity relating to that foreign operation shall be reclassified to profit or loss when the gain or loss on disposal is recognized.

In addition to the disposal of an entity's entire interest in a foreign operation, the following are accounted for as disposals even if the entity retains an interest in the former subsidiary, associate or jointly controlled entity:

(a) the loss of control of a subsidiary that includes a foreign operation;

(b) the loss of significant influence over an associate that includes a foreign operation; and

(c) the loss of joint control over a jointly controlled entity that includes a foreign operation.

On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be de-recognized, but shall not be reclassified to profit or loss.

On the partial disposal of a subsidiary that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences recognized in other comprehensive income to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation the entity shall reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognized in other comprehensive income.

Disclosure

An entity shall disclose:

(a) the amount of exchange differences recognized in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with IAS 39; and

(b) net exchange differences classified in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency.

When an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency and the requirements of this IAS are not met, it shall:

(a) clearly identify the information as supplementary information to distinguish it from the information that complies with International Financial Reporting Standards;

(b) disclose the currency in which the supplementary information is displayed; and

(c) disclose the entity's functional currency and the method of translation used to determine the supplementary information.

Recommended Approach

- ascertain group structure
- make any fair value adjustments
- translate subsidiary's statement of financial position into presentation currency
- calculate goodwill, MI and reserves
- complete consolidated statement of financial position
- translate subsidiary's IS into presentation currency
- calculate exchange differences on translation
- analysis of total exchange differences
- complete CIS
- complete statement of changes of equity

Examples of Monetary and Non-monetary assets/liabilities

- MONETARY ASSETS
  - Cash and due from banks
  - Marketable debt securities
  - Trade receivables
  - Notes receivables
  - Other receivables
- NON-MONETARY ASSETS
  - Prepaid expenses
  - Advances to suppliers
  - Marketable equity instruments
  - Investment in associates
  - Property, plant and equipment
  - Intangible assets
  - Deferred tax assets
- MONETARY LIABILITIES
  - Trade payables
  - Accrued expenses
  - Taxes and withholding taxes payables
  - Borrowings
  - Notes payables
- NON-MONETARY LIABILITIES
  - Advances from customers
  - Deferred income
  - Shareholder's equity
  - Deferred tax liability

Example-1

KP a dollar based entity, was involved in the following transactions in foreign currencies during the year ended December 31, 20X3.

a) KP bought equipment for 130,000 Dinars on March 04, 20X3 and paid for on August 25, 20X3 in Dollars.

b) On February 27 20X3 KP sold goods which had cost $46,000 for $68,000 to a company whose currency was Krams. The proceeds were received on May 25, 20X3.

c) On September 02, 20X3 KP sold goods which cost $17,000 for $ 24,000 to a company whose currency was Sarils. The amount was outstanding at December 31, 20X3 but the proceeds were received in sarils on February 07, 20X4 when the exchange rate was S 2.306=$1, the directors of KP approved the final accounts on March 28, 20X4.

d) KP borrowed 426,000 rolands on May 25, 20X3 and is repayable in two years time.

Exchange rates relevant to the above transactions to $1 are given below: -

At	Rolans (R)	Dinars (D)	Krams (K)	Saril (S)
Feb 27, X3	--	--	7.0	--
Mar 4, X3	--	0.65	--	--
May 25, X3	1.5	--	6.7	--
Aug 25, X3	--	0.50	--	--
Sep 2, X3	--	--	--	2.224
Dec 31, X3	1.8	0.54	7.5	2.250

Required: -

For each of the above transactions calculate the gross profit or loss and foreign currency gain or loss which would be included in the company's final accounts for the ended December 31, 20X3 as required by IAS-21.

Example-2

Memo, a public limited company, owns 75% of the ordinary share capital of Random, a public limited company which is situated in a foreign country. Memo acquired Random on 1 May 20X3 for 120 million crowns (CR) when the retained profits of Random were 80 million crowns. Random has not revalued its assets or issued any share capital since its acquisition by Memo. The following financial statements relate to Memo and Random:

STATEMENTS OF FINANCIAL POSITION AT 30 APRIL 20X4

	Memo	Random
	$m	**CR m**
Property, plant and equipment	297	146
Investment in Random	48	–
Loan to Random	5	–
Current assets	355	
	102	
	705	248
Equity		
Ordinary shares of $1/1CR	60	32
Share premium account	50	20
Retained earnings	360	95
	470	147
Non current liabilities	30	41
Current liabilities	205	60
	705	248

INCOME STATEMENTS FOR YEAR ENDED 30 APRIL 20X4

	Memo	Random
	$m	**CR m**
Revenue	200	142
Cost of sales	(120)	(96)
Gross profit	80	46
Distribution and administrative expenses	(30)	(20)
Profit from operations	50	26
Interest receivable	4	–
Interest payable	-	(2)

Profit before taxation	54	24
Income tax expense	(20)	(9)
Profit after taxation	34	15

The following information is relevant to the preparation of the consolidated financial statements of Memo.

(a) Goodwill is reviewed for impairment annually. At 30 April 20X4, the impairment loss on recognized goodwill was CR4.2m.

(b) During the financial year Random has purchased raw materials from Memo and denominated the purchase in crowns in its financial records. The details of the transaction are set out below:

	Date of transaction	Purchase price	Profit percentage on selling price
		$m	
Raw materials	1 February 20X4	6	20%

At the year end, half of the raw materials purchased were still in the inventory of Random. The intra-group transactions have not been eliminated from the financial statements and the goods were recorded by Random at the exchange rate ruling on 1 February 20X4. A payment of $6 million was made to Memo when the exchange rate was 2·2 crowns to $1. Any exchange gain or loss arising on the transaction is still held in the current liabilities of Random.

(c) Memo had made an interest free loan to Random of $5 million on 1 May 20X3. The loan was repaid on 30 May 20X4. Random had included the loan in non-current liabilities and had recorded it at the exchange rate at 1 May 20X3.

(d) The fair value of the net assets of Random at the date of acquisition is to be assumed to be the same as the carrying value.

(e) The functional currency of Random is the Crown.

(f) The following exchange rates are relevant to the financial statements:

	Crowns to $
30 April/1 May 20X3	2·5
1 November 20X3	2·6
1 February 20X4	2·5
30 April 20X4	2·1
Average rate for year to 30 April 20X4	2·5

(g) Memo has paid a dividend of $8 million during the financial year and this is not included in the income statement.

It is the group's policy to value the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare a consolidated statement of comprehensive income for the year ended 30 April 20X4 and a consolidated statement of financial position at that date in accordance with International Financial Reporting Standards.

Past Papers

Q-1

SOFT TECH LTD is a public limited company incorporated in Pakistan in January 2000. SOFT TECH purchased the whole of the share capital of E-TECH L.L.C., a company incorporated in Jabel Ali Free Zone of Dubai. The agreed price of Rs. 9 million was remitted through Pakistan on July 1, 2003. Fixed assets and intangible assets (software) were revalued for the purpose of the acquisition and the balance sheet as of July 1, 2003 has been based on these valuations.

E-TECH L.L.C. UAE
BALANCE SHEET AS ON JULY 1, 2003

	UAE Dirhams
Share capital	150,000
Revaluation reserve	60,000
Un-appropriated profit	195,000
Long term loan	225,000
	630,000
Fixed assets	400,000
Intangible assets (softwares)	150,000
Net current assets	80,000
	630,000

The summarized accounts for June 30, 2004 of both the companies are as follows:

	SOFT TECH Rs. 000	E-TECH UAE Dirhams
PROFIT AND LOSS ACCOUNT		
Operating profit	144,000	75
Less Income tax	57,000	-
- Net profit for the year	87,000	75
Un-appropriated profit b/f	20,000	195
Un-appropriated profit c/f	107,000	270
BALANCE SHEET		
Share capital	400,000	150
Revaluation reserve	--	60
Unappropriated profit	107,000	270
Long term loan	19,000	225
	526,000	705
Fixed assets	426,000	360
Intangible assets (software)	46,000	100
Net current assets	45,000	245
Investment in subsidiary	9,000	
	526,000	705

Relevant exchange rates (Pak Rupees per UAE Dirham):

July 1, 2003	15
Average for the year	15.88
June 30, 2004	16

Required:
Prepare consolidated accounts for SOFT TECH and its subsidiary for the year ended June 30, 2004 as per the requirement of relevant International Accounting Standards (IASs).

Q-2

Rainbow Textiles Limited (RTL) is a public limited company and owns 70% holding in Fabrics Design Limited (FDL).

FDL is located in a foreign country and its functional currency is FC. RTL acquired FDL on July 1, 2009 for FC 12 million when FDL's share capital and retained earnings were FC 5 million and FC 3 million respectively. On the acquisition date, fair value of FDL's net assets was FC 11 million. The fair value of all the assets except leasehold land and buildings was equal to their carrying amounts. The remaining lease period of the land and useful life of the buildings at the date of acquisition was 20 years. RTL and FDL use straight line method of depreciation.

The following balances were extracted from the Statement of Comprehensive Income of RTL and FDL for the year ended June 30, 2010:

Statement of comprehensive income

	RTL	**FDL**
	Rs. (m)	**FC (m)**
Sales revenue	1,000	25
Cost of sales	(450)	(15)
Gross profit	550	10
Selling and administrative expenses	(250)	(5)
Financial expenses	(25)	(1)
Profit before taxation	275	4
Taxation	(100)	(1)
Profit after taxation	175	3

The following additional information is also available:

(i) On April 10, 2010 RTL sold goods for Rs. 30 million to FDL at a margin of 20% of selling price. Full payment was made by FDL on May 1, 2010. No exchange gain or loss was recorded on the transaction. Goods valuing FC 1.0 million were still in closing inventory of FDL as of June 30, 2010.

(ii) An impairment test was carried out on June 30, 2010 which indicated that the goodwill has been impaired by 25%.

(iii) RTL follows a policy of valuing the non-controlling interest at its proportionate share of fair value of the subsidiaries' identifiable net assets.

(iv) FDL has not issued any shares after the acquisition.

(v) Exchange rates relevant to the preparation of the financial statements are as follows:

	1FC = Rs
30-06-09	22.00
01-07-09	22.00
10-04-10	22.50
01-05-10	23.00
30-06-10	23.50
Average rate for the year	22.75

Required:

Prepare the Consolidated Statement of Comprehensive Income of Rainbow Textiles Limited for the year ended June 30, 2010.