

IND AS: FUNCTIONAL CURRENCY AND CONSEQUENTIAL IMPACT ON DEFERRED TAX

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Executive summary

This article covers the 'Functional Currency' aspect differentiating with 'Presentation Currency' as laid in Ind AS 21, which will be a new concept when India converges to IFRS.

It also highlights the consequential impact of having two sets of functional currencies (one for GAAP reporting and other Tax submissions) on deferred tax computation under Ind AS 12, which again is based on a new approach i.e., 'Temporary difference' as against 'Timing difference' under existing AS-22.

Temporary difference is essentially arrived at by comparing the balance sheet under tax books with financial books. This approach is also known as 'Balance Sheet approach' and the approach in AS-22 is termed as 'P&L approach'.

Introduction

India has laid down the convergence plan of 'Indian Accounting Standards' (AS) with 'International Financial Reporting Standards' i.e., IFRS in a phased manner. The first phase implementation was expected to begin from April 1, 2011 but due to practical challenges, the implementation is delayed. ICAI, as part of convergence approach, has come out with 35 Ind AS which are the same as IFRS except for the carve-outs. The Ministry of Corporate Affairs (MCA) has notified 35 Ind ASs on February 25, 2011.

Amongst these standards, there is one standard that has the potential to entirely turn the Indian financial statements topsy turvy and that is IAS 21 i.e., Ind AS 21. **The consequential impact of this standard on deferred taxes, is not part of the carve-outs and hence would need due care while the standard is implemented in India.**

Currency for accounting and presentation

While all Indian entities prepare books of accounts in Indian Rupees, we have never thought of preparing our books in any other currency. There may be some who did wish of using currency other than Indian Rupee (INR) on account of huge foreign exchange

exposures, but they did not have any guidance or literature to support them. The spot will now be addressed in 'Ind AS 21 — The Effects of Changes in Foreign Exchange Rates'.

Once India starts converging to Ind AS, we will have this standard on effects of exchange fluctuations, which has considered the aspect of huge volatility and exposures to operations due foreign currency (i.e., other than INR). It requires the managements of companies to adopt a suitable currency for maintaining their accounts. Since the entities may vary their exposures to currency in different years, the standard has mandated the assessment of such book-keeping currency every year.

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If any other currency, say, USD is considered as the currency that influences the primary economic environment, managements will have to prepare themselves to consider INR as foreign currency exposure and mark to market all INR monetary assets and liability at each balance sheet date.

Ind AS 21 — 'The Effects of Changes in Foreign Exchange Rates' is a standard that brings a new dimension to the financial statements prepared in India. Now, the book-keeping currency i.e., Functional currency will no more be optional or default INR, it will be governed by specific principles laid down under the standard and functional currency can be different than the presentation currency.

Functional currency

Let us appreciate the governing principles of functional currency under Ind AS 21:

"Functional currency is the currency of the **primary economic** environment in which the entity operates." (para 7)

"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 labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled)." (para 8)

Ind AS 21 defines the functional currency and differentiates it from the presentation currency. The primary factor that drives the choice of currency is influenced by stream of revenue and operating costs. Additional factors that the standard requires to examine are the currency of loan obligations.

"Many reporting entities comprise a number of individual entities (e.g., A group is made up of a parent and one or more subsidiaries). Various types of entities, whether members of a group or otherwise, may have investments in associates or joint ventures. They may also have branches. It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity presents its financial statements. **This Standard permits the presentation currency of a reporting entity to be any currency (or currencies).** The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with paragraphs 38-50." (para 10)

Under existing AS-11 definitions, foreign currency is a currency other than the reporting currency, and reporting currency is the currency used for reporting financial statements. The rules of translating the subsidiary accounts into reporting currency are similar to those under Ind AS 21, which prescribes using closing rate for balance sheet items and transaction rate or average rate for income statement items (para 38-50).

Point of difference

Under Indian GAAP, a currency used for preparing as well as reporting i.e., presenting financial statements to regulatory authorities, lenders, investors, etc. is foreign currency is no other than INR. There is no concept of having the currency to report financial statements (presentation currency) different from the currency in which books of accounts are to be maintained (functional currency).

Functional currency: Industry perspective

Under Indian GAAP there is no concept of functional currency identification. It however has reference to 'Reporting Currency', which is expected to be the same currency of the country in which it is domiciled.

The definition of functional currency in Ind AS will **encompass all the companies whose primary economic environment is not the Indian economy.**

The impact of this standard will be more evident on commodity market-linked companies engaged in **mining, refining, and trading products**, whose primary revenue is governed by international commodity prices prevailing on London Metal Exchange in US Dollars. Another industry that may be impacted by the implementation of Ind AS will be **Business Process Outsourcing Companies and Software Companies** whose primary revenue is again governed in terms of **Dollars and Euros**. Oil and Gas companies are also prone to get functional currency assessment and application in India since the oil prices are quoted in USD per barrel globally.

It will also be impacting the bullion companies that are listed on Indian stock exchanges and others that are planning to list soon on Indian and international bourses. The revenues of these companies are always traded in USD in India and internationally.

Domestic prices for sales within India, of these companies though in INR, are arrived at by first considering the respective International prices in USD and then making certain adjustments such as duty differentials, domestic market premium, freight differentials, competitive discounts, etc. which in industry terms is called as 'Shadow Gap' pricing.

Each company will have to apply its own judgment and access all the criteria of primary environment and other additional factors that influence the choice of its functional currency.

Challenges on adoption of functional currency other than INR in India:

- (1) If the accounting records of these Indian companies are to be prepared under Ind AS, then the financial statements will altogether give a different picture. Since currency fluctuation on, say, USD may now sit in transaction amounts and change company's profitability.
- (2) Change in mindset and budgets required.
- (3) Will lead to difficulty in decision-making processes by Indian managements specifically in assessing its foreign exchange exposure which so far was on currencies other than INR.
- (4) Continuing a parallel accounting system for Income Tax submission since Direct Tax Code does not provide for similar changes.
- (5) Updation/modification to ERP solutions. It is also worth noting that accounting softwares such as SAP have a functionality to address the dual currency accounting which can take care of both tax reporting using INR as functional currency and IFRS reporting using any other currency.
- (6) **Accounting for deferred tax and unwanted volatility in income statement.**

Indian Industry including managements, lenders, investors, analysts of financial statements will have to prepare for seeing a currency different than INR as accounting currency in annual financial statements. Many companies internationally have adopted this standard which aligned their accounting currency i.e., functional currency in line with their respective primary economic environments.

In the international markets most of the transactions happen in US Dollars and India is now a part of a global economic platform and thus is very much influenced by USD in its financial statements. The impact is more evident in industries that are primarily dependent on USD and whose profitability is affected by any change in USD: INR exchange rate such as Mining & Metals, Oil & Gas, Software exports and Business Processing Operations among others.

Let us now appreciate the challenge in point 6 above, on how deferred tax is impacted by change in func-

tional currency from INR

Ind AS 12: Income Taxes

A deferred tax asset or liability shall be recognised for all taxable temporary differences.

'Temporary differences' are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. The 'tax base' of an asset or liability is the amount attributed to that asset or liability for tax purposes.

The primary approach of accounting of deferred tax under Ind AS is using the balance sheet approach. For example, revaluation of fixed assets under Indian the GAAP with no corresponding revaluation in tax books i.e., tax base has no impact on deferred tax computation under AS-22 since the revaluation impact is only a balance sheet adjustment with corresponding impact directly in reserves.

Under Ind AS 12, even though the revaluation does not impact the income statement, there is a requirement to adjust the deferred tax and post the net impact in revaluation reserve. This is because this originates a temporary difference on comparison between the balance sheet value of asset and tax base for that particular asset. This is true for all such differences between the balance sheet value and tax base, that have a potential of reversal either in tax books such as 43B items or financial books itself such as revaluation adjustments.

While comparing the balance sheet values and tax base, the following paragraph of Ind AS 12 brings out the impact of functional currency on deferred tax computation.

"The non-monetary assets and liabilities of an entity are measured in its functional currency (see Ind AS 21 The Effects of Changes in Foreign Exchange Rates). If the entity's taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss." (Para 41)

The application of this paragraph will not trigger if the

currency in which the company maintains its books of accounts i.e., functional currency and the ones used for calculating taxable profit under tax laws is the same i.e., INR for India. It is pertinent to note that choosing a different currency for presentation of financial statements to stock market, lender, investors, etc., will not attract application of paragraph 41 of Ind AS 12.

However, with the change in accounting standard wherein the accounting records may have to be made under, say, USD (considering primary economic

- (4) Example considers only non-monetary assets assuming monetary assets are valued at closing rate and thus would not lead to any difference while comparing the tax base using translation rate.
- (5) The exchange rate at March 31 is 1 USD = Rs. 50 and tax rate is 33.99%

Closing deferred tax status of deferred tax liability as on March 31, XXXX of Entity A is as shown in Table 1:

TABLE 1

Particulars	March 31 – XXXX		Equivalent	Diff	Tax	Def tax
Non monetary assets	INR – Tax	USD – A/c	USD – Tax	INR	Rate	USD
	A	B	C=A/50	D=B-C	E	F=D*E
Property, plant and equipment	2,500.00	62.50	50.00	12.50	33.99%	4.25
Intangible assets	200.00	5.00	4.00	1.00	33.99%	0.34
Other assets	150.00	3.41	3.00	0.41	33.99%	0.14
Inventories	300.00	6.82	6.00	0.82	33.99%	0.28
Total	3,150.00	77.73	63.00	14.73		5.01

environment criteria under Ind AS 21) and taxable profit or loss is to be calculated under INR, this may cause the temporary difference if the USD:INR exchange rates changes at every balance sheet date.

We will take an example to understand the implications of functional currency on deferred tax.

- (1) Entity A has INR as tax currency and USD as functional currency.
- (2) The value of non-monetary assets as maintained for tax books in INR is Rs.3,150 and as maintained with USD as functional currency stood at \$77.73.

The transactions under both sets of books were accounted at respective historical exchange rates and thus the INR numbers of tax books when divided by USD numbers of financial books, will give historical transaction rates, thus different from the closing rate.

- (3) The original and subsequent cost under tax base for the assets are the same as that in financials books, with the exception to the difference that originates due to application of para 41 of Ind AS 12.

Deferred tax under Ind AS will be calculated as follows:

Under Ind AS, the deferred taxes are measured in the functional currency

Carrying value in the functional currency	=	\$77.73
Tax base translated in functional currency i.e., USD at the rate on closing date is USD = Rs.3,150/50	=	\$ 63
Temporary difference: (\$77.73-\$63.00)	=	\$14.73
Tax rate	=	33.99%
Deferred tax expense	=	\$ 5.01

As can be seen from the above calculation, the translation of tax base using closing rate has led to a difference of \$14.73. It is pertinent to note that this difference is only for deferred tax computation and not for accounting in the financial books.

The notional comparison has reduced the tax base in USD by 14.73 and this leads to creation of a deferred tax liability with a corresponding deferred tax expense

in the income statement. The impact of \$ 5.01 over net assets of \$ 63 will be a material impact on the profits of the company. It will vary depending upon the value of non monetary assets as on the reporting date and movement of exchange rates during the period.

There would not have been any temporary difference in the above example if the functional currency was INR, since tax base and book base would have been the same.

Impact of accounting of deferred tax such functional currency difference

- (1) The accounting for deferred tax on account of such notional differences creates high volatility in the income statement.
- (2) The gain/loss on account of such treatment has no corresponding charge/income in the income statement. It is accounted based on pure out of books comparison of exchange rates on non-monetary items. (\$14.05 is notional only for comparison but tax of \$ 5.01 is real for accounting.)
- (3) This item has no bearing to operations or profit; instead it pulls down/up financial results from operations due to tax provision and thus calls for suitable disclosures in financial statements to explain the earnings per share to investors, analysts, etc.

It is pertinent to note that i.e. US GAAP, Financial Accounting Standard (FAS) 109 prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, Foreign Currency Translation, are re-measured from the local currency into the functional currency using historical exchange rates and that result from (a) changes in exchange rates or (b) indexing for tax purposes.

On the one hand Ind AS 21 aims to reduce the volatility in results on account of currency exposure and on the other hand Ind AS 12 brings in volatility in income taxes on account of notional difference created on account of comparing the balance sheet value and tax base in functional currency at the closing date.

Thus, choice of functional currency other than that

used for tax reporting will lead to such temporary differences and will continue to exist until book currency and tax currency are aligned.

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."

The entity will have to assess the criteria for deciding the functional currency year and apply the accounting impacts for change prospectively. Here the country's policies also would influence the decision such as restrictions on holding foreign currency and INR being the only legal tender in India.

The entity will also have to explain in notes to financial statement as to why it considers such change in its functional currency.

Presentation currency

Ind AS 21 allows the entity to present its financial statements in any currency and does not restrict any one currency.

However, considering the Indian requirements for ROC filing, tax submission, stock exchange filings, etc. the presentation currency will be preferred to be INR.

INR as the presentation currency in Indian market will also be preferred currency for reporting to facilitate easy comparability with its peer group. This can be achieved by either following the rules of translation (using average rate for income statement and closing rate of balance sheet) which will give rise to translation reserve or convenient translation using a single rate for all the items in the balance sheet and income statement.

International precedence

In order to relate to the new concept, financial statements of some international companies who have gone through the change in functional currency may be referred. Following relevant excerpts are for reference:

"StatoilHydro (OSE:STL; NYSE:STO) changed the company structure as per 1st January 2009. The parent company, StatoilHydro ASA, and two subsidiaries, consequently changed their functional currencies to USD from the same date.

Considering the Indian requirements for ROC filing, tax submission, stock exchange filings, etc. the presentation currency will be preferred to be INR.

The accounts for these companies are therefore now recorded in USD, while the presentation currency for the Group remains NOK. The changes in functional currencies have no cash impact.

The companies changing functional currency will no longer have currency exchange effects, deriving from USD denominated monetary assets and liabilities, related to the 'Net financial items'. Conversely, monetary assets and liabilities, denominated in other currencies than USD, may now generate such currency effects."

Radiance Electronics Limited, Singapore

"Certain subsidiaries of the Group have changed their functional currency from SGD and RMB to USD in FY2008A. Revenue for these subsidiaries is mainly denominated in USD while purchases are mostly made in USD. Administrative expenses are denominated based on their country of domicile and are mainly in SGD and RMB.

While the factors used to determine its functional currencies are mixed, the Company is of the opinion that USD best reflects the economic substance of the underlying transactions and circumstances relevant to the foregoing subsidiaries. Accordingly, the subsidiaries adopt USD as its functional currency with effect from the current financial year ended 31st December 2008. This change shall be applied retrospectively to the prior years.

The Company and the Group continues to present its financial statements in SGD consistent with prior years."

For deferred tax implications under IFRS Tenaris S.A.'s annual financial statements may be referred. It carries a note in its financial statements under 'Tax reconciliation note' to explain the investors and readers on the volatility caused due to tax accounting.

Tax note from Tenaris S.A. 2008 financial statements

"Tenaris applies the liability method to recognise deferred income tax expense on temporary differences between the tax bases of assets and their carrying amounts in the financial statements. By application of this method, Tenaris recognises gains and losses on deferred income tax due to the effect of the change

in the value of the Argentine Peso on the tax bases of the fixed assets of its Argentine subsidiaries, which have the U.S. Dollar as their functional currency. These gains and losses are required by IFRS even though the devalued tax basis of the relevant assets will result in a reduced Dollar value of amortisation deductions for tax purposes in future periods throughout the useful life of those assets. As a result, the resulting deferred income tax charge does not represent a separate obligation of Tenaris that is due and payable in any of the relevant periods."

Internationally it was easier for companies to adopt a change in currency of accounting since these are fully convertible economies i.e., they can operate bank accounts in foreign currency. Thus the change in mindset was comparatively easier, however the common challenge was again ERP which had to be equipped with dual currency reporting for tax purposes.

With respect to deferred taxes, we can see that note in financial statements was given to explain notional volatility to guide the analysts and readers of financial statements.

Forward path

It will be a challenging journey for Indian corporates who will adopt Converged IFRS i.e., 'Ind AS' and will have to consider the implications of these standards on its accounting and reporting requirements.

From stability of profitability and ultimately EPS perspective, the companies may avoid the volatility of currency exposure, but may not escape the volatility created by foreign exchange rates in computing deferred taxes. In order to explain the volatility on deferred tax front, companies may prefer to give note disclosures as given by international peers.

Alternative approach: Ind AS 12 'Income Taxes'

Considering the amount of volatility of foreign exchange rates with INR and its notional impact on financial statements, the Institute of Chartered Accountants of India can consider a 'Carve-out' while converging to IAS 12 or represent to International Accounting Standards Board for granting an exemption under IAS 12 which will flow in Ind AS 12. This is keeping in mind the deferment of Ind AS implementation in India and practical hardships that will be faced by Indian multinational conglomerates.

