# AS 11: The Effects of Changes in Foreign Exchange Rates

## Introduction

- AS 11, (revised 2003), comes into effect in respect of accounting periods commencing on or after 1-4-2004.
- Mandatory in nature from that date.
- The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognize the financial effects of changes in exchange rates in the financial statements.
- The standard requires the enterprises to disclose
  - (i) The amount of exchange differences <u>included in the net profit or loss</u> for the period
  - (ii) The amount of exchange differences <u>adjusted in the carrying amount of fixed assets</u>,
  - (iii) The amount of exchange differences in respect of <u>forward exchange contracts to be recognized in the profit or loss in one or more subsequent accounting periods</u>.

## Scope

Applies to:

(a) The transactions in <u>foreign currencies</u>.

(b) The financial statements of <u>foreign operations</u>.

(c) <u>Forward exchange contracts</u>

This standard does not:

(a) Specify the **currency** in which an enterprise presents its financial statements.

(b) Deal with the presentation in a **cash flow statement**

(c) Deal with the borrowings to the extent that they are regarded as **an adjustment to interest costs.**

(d) Deal with the restatement of an enterprise's financial statements from its reporting currency into another currency **for the convenience of users.**

## Definitions

A) **Foreign currency**: A currency other than the reporting currency of an enterprise

B) F**oreign currency transaction**: A transaction which is denominated in or requires settlement in a foreign currency which includes (a) <u>Buying or selling goods or services</u>. (b) <u>Borrowing or lending funds</u>. (c)

Outperformance of forward exchange contract or (d) Acquiring or disposing of assets, or incurring or settling liabilities, denominated in a foreign currency.

C) **Monetary items**: Money held and assets and liabilities to be received or paid in fixed amount. *e.g. cash, receivables and payables*

D) **Non-monetary items**: Assets and liabilities other than monetary items. *e.g. fixed assets, inventories and investments in equity shares (as they are not in fixed amount.)*

E) **Foreign operation:** A subsidiary, associate, joint venture or branch of the reporting enterprise, in a country other than the country of the reporting enterprise. Which are of two types:

   i) **Integral Foreign Operation(IFO)**: A foreign operation, the activities of which are an integral part of those of the reporting enterprise and they carries business as if it were an extension of the reporting enterprise's operations.

   ii) **Non- Integral Foreign Operation (NIFO)**: A foreign operation that is not an integral foreign operation. The change in the exchange rate affects the reporting enterprise's net investment in the NIFO rather than the individual monetary and non-monetary items.

F) **Forward exchange contract**: An agreement to exchange different currencies at a forward rate i.e. the specified exchange rate for exchange of two currencies at a specified future date.

## Initial Recognition

On initial recognition in the reporting currency, a foreign currency transaction should be recorded by applying exchange rate at the date of the transaction. But an approximate rate is often used *e.g. an average rate for a week or a month might be used for all transactions*

However, the use of the average rate for a period is unreliable if exchange rates fluctuate significantly.

## Reporting at each balance sheet date

The treatment of foreign currency items at the balance sheet date depends on whether the item is:

• Monetary or non-monetary; and

• Carried at historical cost or fair value (for non-monetary items).

(a) Foreign currency **monetary items** should be reported using the **closing rate**. *However, in certain circumstances, the closing rate may not reflect with reasonable e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to disburse, such item at the balance sheet date*.

(b) **Non-monetary** items which are carried in terms of **historical** should be reported using the **exchange rate at the date of the transaction.**

(c) **Non-monetary** items which are carried at **fair value** should be reported using the exchange rates that existed **when the values were determined.**

(d) **The contingent liability** in foreign currency at the balance sheet date is disclosed by using the **closing rate.**

## Recognition of Exchange Differences

Exchange differences arise on:

• The settlement of monetary items at a date subsequent to initial recognition; and • Remeasuring an enterprise's monetary items at rates different from those at which they were either initially recorded or previously recorded (at the previous balance sheet date).

When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognized in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognized in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Illustration

A Ltd. purchased fixed assets costing Rs. 3,000 lakhs on 1.1.2011 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs. 40.00 and Rs. 42.50 as on 1.1.2011 and 31.12.2011 respectively. First instalment was paid on 31.12.2011. The entire difference in foreign exchange has been capitalized.

You are required to state, how these transactions would be accounted for.

Solution

As per AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or expenses in the period in which they arise.

Calculation of Exchange Difference:

Foreign currency loan = Rs. 3000 lakhs ÷ Rs. 40 = 75 lakhs Dollars

Exchange Difference = 75 lakhs Dollar × (42.50 - 42.00)

=Rs. 187.50 lakhs

(Including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting Rs. 187.50 lakhs should be charged to profit and loss account for the year.

## Classification of Foreign Operations as IFO or NIFO

The method depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either 'IFOs' or 'NIFOs'.

**An IFO** carries on its business as if it were an extension of the reporting enterprise's operations. *e.g., such an operation might only sell goods imported from the reporting enterprise and remits the proceeds to the reporting enterprise.* In such cases, a change in the exchange rate between the reporting currency and the currency in foreign operation has an almost immediate effect on the cash flow of reporting enterprise. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than net investment in that operation.

**A NIFO** accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows of either The Non-IFO or The Reporting Enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the NIFO rather than the individual monetary and non- monetary items held by the NIFO.

## Translation of Foreign Integral Operations

The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise.

- The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation.
- The cost of inventories is translated at the exchange rates that existed when those costs were incurred.
- The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined, e.g. when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

Illustration

Assets-liabilities and income-expenditure items in respect of foreign branches are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to revenue. Comment.

Solution

<u>Conclusion</u>: The financial statements of an IFO (for example, dependent foreign branches) should be translated using the principles and procedures described in AS 11 (Revised 2003). The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

<u>What AS Says</u>: Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. The foreign currency monetary items (for example cash, receivables and payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange date at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. <u>The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate</u>. Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account. *Exchange difference arising on the translation of the financial statement of foreign operation may have tax effect which should be dealt as per AS 22 'Accounting for Taxes on Income'.*

<u>Comment</u>: Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11 (Revised 2003).

## Translation of Non-Integral Foreign Integral Operations

- Exchange differences accumulated in a foreign currency translation reserve (**until** the disposal of the net investment).
- The assets and liabilities (both monetary and non-monetary) => <u>closing rate</u>;
- Income and expense => exchange rates at the dates of the transactions;
- Goodwill or capital reserve (arising on the acquisition of a NIFO => closing rate.
- A contingent liability => closing rate

- The incorporation of the financial statements of a NIFO in reporting enterprise follows normal consolidation procedures. However, an exchange difference arising on an intra-group monetary item cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.
- The exchange differences are not recognized as income or expenses for the period because the changes have little or no direct effect on the present and future cash flows from either the NIFO or the reporting enterprise.
- When a NIFO is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of the minority interest in the consolidated balance sheet.

Indications for foreign operation is a NIFO rather than an IFO:

1. When the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise even if reporting enterprise controls the same,
2. Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.
3. The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.
4. Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local Currency than in the reporting Currency.
5. The foreign operation's sales are mainly in currencies other than the reporting currency.
6. Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation as it is not directly affected by the activities of the foreign operation.
7. Sales prices for the foreign operation's products are not primarily responsive on a short term basis to changes in exchange rates but are determined by local competition or local government regulation.
8. There is an active local sales market for the foreign operation's products, even there is significant amounts of exports.

## Change in the Classification of a Foreign Operation

When an IFO is reclassified as a NIFO, exchange differences arising on the translation of **non-monetary** assets at the date of the reclassification are accumulated in a foreign currency translation reserve.

When a NIFO is reclassified as an IFO, the translated amounts for **non-monetary** items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognized as income or expenses until the **disposal of the operation**.

## Forward exchange contract

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortized as expense or income over the life of the contract.

Exchange differences => in statement of profit and loss in the reporting period.
Any profit or loss on cancellation or renewal of FEC => income or as expense.
In recording an FEC intended for trading or speculation purposes then the premium or discount on the contract is ignored and at each balance sheet date the value of the contract is marked to its current market value and the gain or loss is recognized

Illustration

Mr. A bought a forward contract for three months of US$ 1,00,000 on 1st December at 1 US$ = Rs. 47.10 when exchange rate was US$ 1 = Rs. 47.02. On 31st December when he closed his books exchange rate was US$ 1 = Rs. 47.15. On 31st January, he decided to sell the contract at Rs. 47.18 per dollar. Show how the profits from contract will be recognized in the books.

Solution

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

| | Rs. |
|---|---|
| Sale Rate | 47.18 |
| *Less*: Contract Rate | (47.10) |
| Premium on Contract | 0.08 |
| Contract Amount | $ 1,00,000 |
| Total Profit | |
| (1,00,000 x 0.08) | Rs. 8,000 |

## Disclosure

An enterprise should disclose:

(a) Differences included in the net profit or loss for the period.

(b) Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) The nature of the change in classification;

(b) The reason for the change;

(c) The impact of the change in classification on shareholders' funds; and

(d) The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.