

Ind AS 21

**The Effects of Changes in
Foreign Exchange Rates**

Terminology

- ▶ The Standard uses the following terms
 - ▶ Foreign Currency is the currency other than the functional currency
 - ▶ Functional Currency is the currency of the primary economic environment in which the entity operates
 - ▶ Presentation Currency is the currency in which the financial statements are presented

Functional currency – determination

- ▶ Following **Primary Indicators** are considered for determination of Functional Currency
 - (a) the currency:
 - ▶ that mainly influences sales prices for goods and services
 - ▶ 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

Functional currency – determination (cont'd.)

- ▶ Where the functional currency of the entity is not obvious from the above, then the standard indicates that the following factors may also provide evidence of an entity's functional currency
 - ▶ the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated
 - ▶ the currency in which receipts from operating activities are usually retained

Functional currency – determination (cont'd.)

- ▶ The standard also says that 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:
 - ▶ 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
 - ▶ whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities
 - ▶ 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
 - ▶ 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

Functional currency – determination (cont'd.)

► Example

- Holding Company H Ltd has a business of supplying raw Iron Ore to major Steel Makers abroad. For this purpose it engages its subsidiary S Ltd in Japan. S Ltd which takes orders from Japanese customers and receives goods from the holding. It also collects proceeds which is always in Japanese Yen & remits it to the parent company. Whole of the funding of the subsidiary is being managed by the parent company including administration and other expenses. There is no other role being played by S Ltd.
- Determine whether the functional currency of H Ltd. (i.e. INR) can be considered as that of the subsidiary S Ltd?

Functional currency – determination (cont'd.)

► Solution

- Since the operations of S Ltd is simply an extension of operations of H Ltd. S Ltd does not have significant degree of autonomy. Hence currency Japanese Yen can not be considered as functional currency of S Ltd. For this purpose the currency of the parent company i.e. INR will be considered as functional currency of the subsidiary also

Functional currency – determination (cont'd.)

► Example

- Entity A Ltd. is an India based holding company of B FZE., based in Oman. The subsidiary was primarily created to execute a construction project in Oman
- 78% of entity B 's finances (debt + equity) have been raised in USD by way of capital contribution from A Ltd. B's bank accounts are maintained in USD as well as Oman's currency Rial (OMR)
- Cash flows generated by B are transferred to A on periodic basis in USD
- Revenues of B are in USD. Its competitors are globally based. Tendering for the construction project happened in USD
- B incurs 70% of the cost in OMR and remaining 30% costs in USD

Since B LLC is a company incorporated in Oman whether it can presume its functional currency to be OMR ignoring all other factors?

Functional currency – determination (cont'd.)

► **Solution**

- No. B FZE needs to consider various factors listed in IFRS for determination of functional currency
- It's significant revenues and its competitive forces are in USD
- Its significant portion of cost is incurred in OMR. Only 30% costs are in USD
- 78% of entity it's finances (debt + equity) have been raised in USD
- It retains its operating cash flows in partially USD and partially in OMR
- Keeping these factors in view, there seems to be case for considering USD to be B's functional currency

Functional currency – determination (cont'd.)

► Example

- Entity A is an importer and retail distributor of cars in Romania. It distributes cars made by a European manufacturer. Entity A's customers are all Romanian customers, half are corporate customers and other half are private
- Corporate customers are usually invoiced in euro, private customers in Romanian Lei. The euro denominated prices of cars in Romania are different from those in other European countries
- The purchase of cars is in euro, because the manufacturer is located in the euro-zone. The remainder of A's operating expenses are incurred locally and are denominated in Romanian lei

Functional currency – determination (cont'd.)

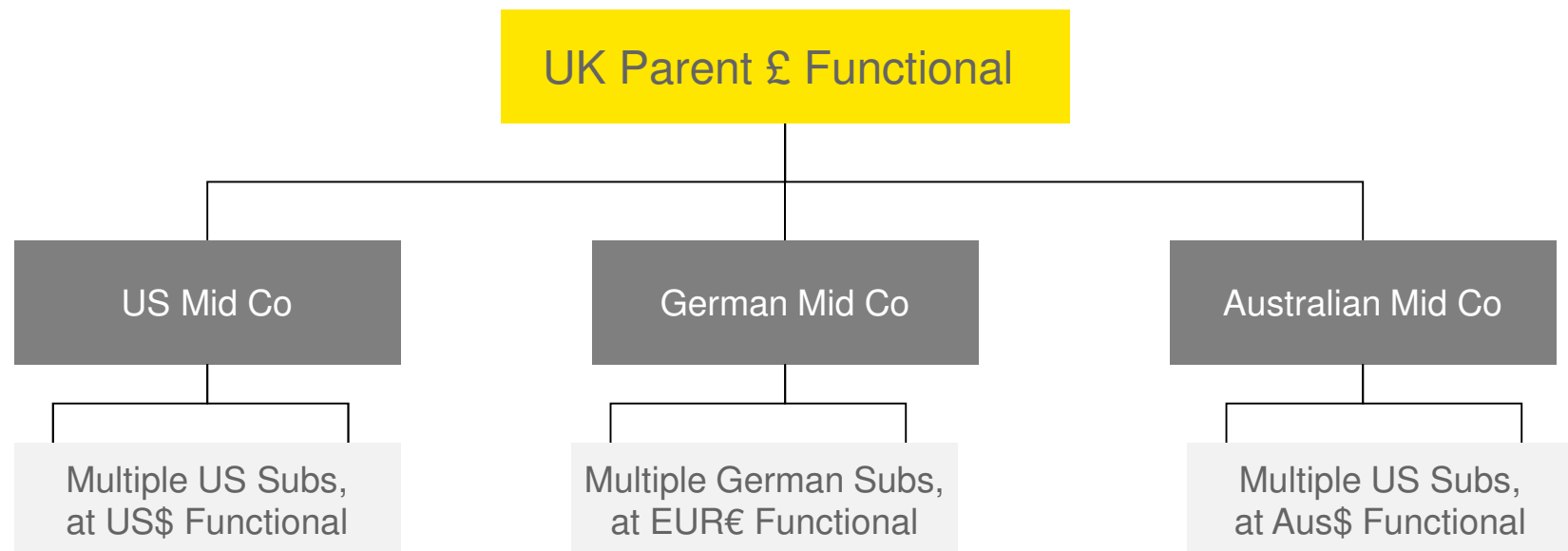
► **Solution**

- The functional currency of entity A is the Romanian lei
- Ind AS 21 gives greater emphasis to the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated
- Sales prices for cars are mainly influenced by the competitive forces and regulations in Romania. The market for cars depends on the economic situation in Romania and the entity is in competition with importers of other car brands. Even though 50% of the income is denominated in euro, Romanian economic conditions are the main factors affecting the prices. This is evidenced by the fact that euro denominated sales prices in Romania are different from euro denominated sales prices for the same cars in other countries
- Management is able to determine the functional currency because the revenue is clearly influenced by the Romanian economic environment and expenses are mixed

Functional currency – determination (cont'd.)

► Example

- An international group is headquartered in the UK. The UK parent company has a functional currency of GBP, and the group's presentation currency is GBP. The group has three international sub-operations, structured as given below. Determine the functional currency of intermediate holding companies.



Functional currency – determination (cont'd.)

- ▶ There are a variety of factors to be considered for intermediate holding companies when deciding on the appropriate functional currency. Therefore, there will not be one right answer for all intermediate holding companies
- ▶ Each entity should be reviewed for its particular circumstances against the indicators of Ind AS 21. The Effects of Changes in foreign Exchange Rates. This review should include the use of judgment by management
- ▶ In the case of an intermediate holding company or finance subsidiary, the acid-test question to consider is whether it is an extension of the parent and performing the functions of the parent – i.e. whether its role is simply to hold the investment in or provide finance to a foreign operation on behalf of the parent company or whether its functions are essentially an extension of a local operation (eg, performing selling, payroll or similar activities for that operation) or indeed it is undertaking activities on its own account

Choice and change of functional currency

Choice

- ▶ An entity does not have a free choice of functional currency
- ▶ An entity cannot change functional currency unless facts and circumstances relevant to its determination change

Change

- ▶ Only if there is a change to the underlying transactions, events and conditions
- ▶ Translation procedures should be applied to the new functional currency prospectively from the date of the change

Translation approach (cont'd.)

- ▶ Functional currency
 - ▶ Determine the Functional Currency
 - ▶ Translate foreign currency items in to functional currency
 - ▶ Report the differences on translation according to the standard
- ▶ Presentation currency
 - ▶ The standard permits presentation of accounts in any currency
 - ▶ If Presentation Currency is different from functional currency then translate the results and financial position in accordance with this standard
- ▶ In a group (with subsidiaries/ associates/ JVs)
 - ▶ Reporting entity (Parent company) presents the group account in any currency (called as Presentation Currency)
 - ▶ Translate other individual entity's accounts into presentation currency of parent (if different)

Translation approach – translation of foreign currency items into functional currency

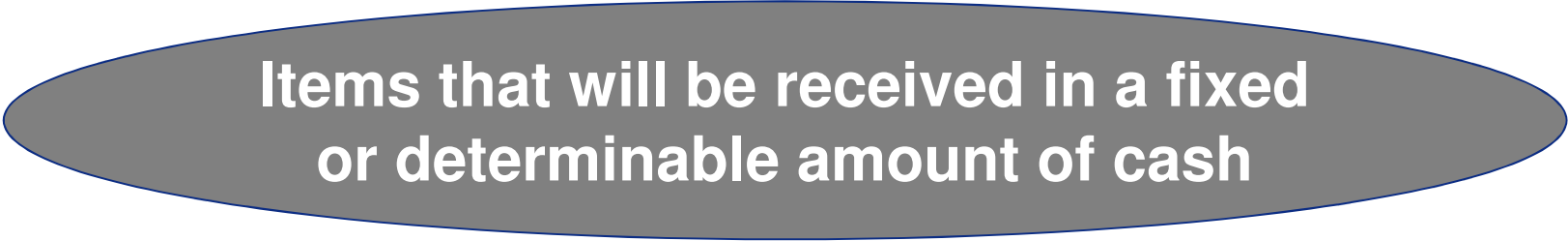
- ▶ Initial recognition
 - ▶ Foreign currency transaction is a transaction that is denominated or requires settlement in foreign currency
 - ▶ Transaction is to be recorded initially by applying the foreign currency amount the spot exchange rate between the foreign currency & the functional currency at the date of transaction
 - ▶ For practical reasons a rate that approximates the actual rate at the date of transaction is often used (e.g. an average rate for a week or a month)
 - ▶ However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate

Translation approach – translation of foreign currency items into functional currency (cont'd.)

- ▶ Subsequent reporting
 - ▶ At the end of each reporting period:
 - ▶ foreign currency monetary items shall be translated using the closing rate
 - ▶ non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction
 - ▶ non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined.

Monetary assets

- ▶ Cash
- ▶ Cash equivalents
- ▶ Debt securities
- ▶ Accounts receivable
- ▶ Notes receivable



**Items that will be received in a fixed
or determinable amount of cash**

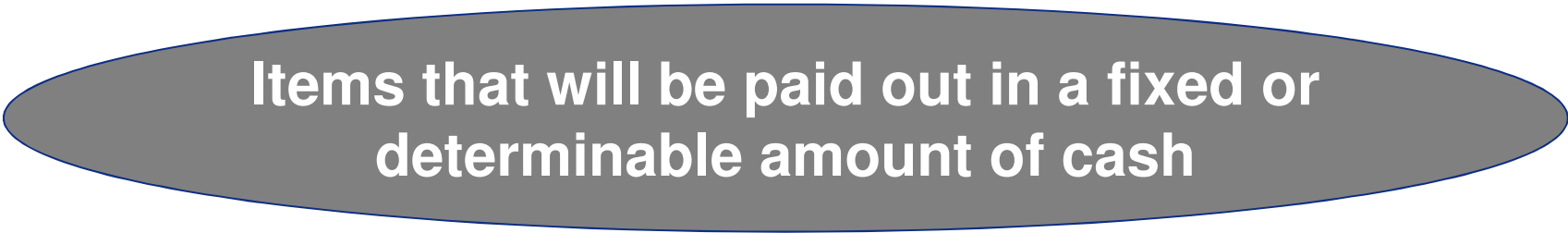
Non-monetary assets

- ▶ Inventory
- ▶ Prepaid expenses
- ▶ Equity securities
- ▶ Investment property
- ▶ Property, plant, and equipment
- ▶ Intangible assets (e.g. goodwill)

Items that will not be received in a fixed or determinable amount of cash

Monetary liabilities

- ▶ Accounts payable
- ▶ Notes payable
- ▶ Bonds payable
- ▶ Leases payable
- ▶ Accruals



**Items that will be paid out in a fixed or
determinable amount of cash**

Non-monetary liabilities

- ▶ Deferred income
- ▶ Government grant

**Items that will not be paid out
in a fixed or determinable
amount of cash**

Translation approach – reporting the differences

- ▶ Recognition of exchange differences
 - ▶ Exchange differences arising on initial or subsequent recognition of monetary items as above or arising on their settlement shall be recognized in profit or loss in the period in which they arise
 - ▶ 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

Case Study

Reporting an unsettled foreign currency transaction in the functional currency

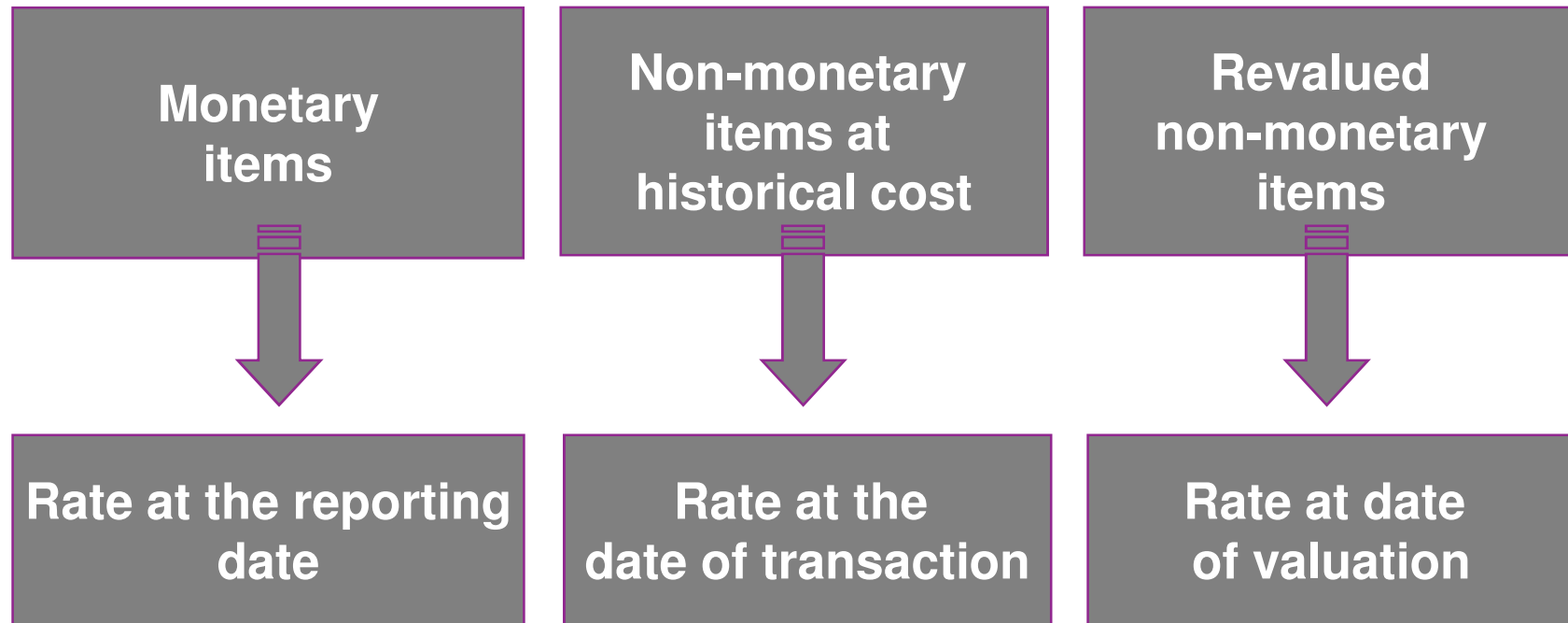
- ▶ A French entity purchases plant and equipment on credit from a Canadian supplier for C\$328,000 in January 2015 when the exchange rate is €1=C\$1.64. The entity records the asset at a cost of €200,000.
- ▶ At the French entity's year end at 31 March 2015 the account has not yet been settled. The closing rate is €1=C\$1.61.
- ▶ The amount payable would be retranslated at €203,727 in the statement of financial position and an exchange loss of €3,727 would be reported as part of the profit or loss for the period.
- ▶ The cost of the asset would remain as €200,000.

Case Study

Reporting a settled foreign currency transaction in the functional currency

- ▶ A UK entity sells goods to a German entity for €87,000 on 28 February 2015 when the exchange rate is £1=€1.45.
- ▶ It receives payment on 31 March 2015 when the exchange rate is £1=€1.50.
- ▶ On 28 February the UK entity will record a sale and corresponding receivable of £60,000. When payment is received on 31 March the actual amount received is only £58,000.
- ▶ The loss on exchange of £2,000 would be reported as part of the profit or loss for the period.

Reporting foreign currency transactions in the functional currency – Subsequent measurement



Translation approach – translation from functional currency to presentation currency

functional currency	Presentation currency
Assets/liabilities	
▶ Current Period	Closing rate (current B/S date)
▶ Comparative period	Closing rate (comparative B/S date)
Equity items	
▶ Current Period	Actual rates (or appropriate average for current period)
▶ Comparative period	Actual rates (or appropriate average for comparative period)
Income/expenses (including those recognised directly in equity)	
▶ Current Period	Actual rates (or appropriate average for current period)
▶ Comparative period	Actual rates (or appropriate average for comparative period)
Exchange differences	Separate component of equity

Explanation of exchange rate difference

- Recalculation of the foreign exchange difference:

Opening equity components x (CR – HR)

+

Net asset changes from P/L x (CR – HR)

+

Net asset changes from other equity transactions x (CR – HR)

=

Translation adjustment in other comprehensive income

CR = Rate at year end (closing rate)

HR = Historical or average rate (as applicable)

Disclosure

- ▶ In accounting policy note disclose that P/L items are translated at rate at transaction dates
- ▶ Reasons:
 - ▶ Why there has been a change in the functional currency
 - ▶ Why the presentation and functional currency are different
- ▶ If entity's additional financial information is displayed in a currency different from either its functional or its presentation currency
 - ▶ Clearly identify such information as supplementary
 - ▶ Disclose the currency of the supplementary information
 - ▶ Disclose the entity's functional currency and the method of translation used as a basis for presenting the supplementary information

Key differences of IGAAP & Ind AS

Particulars	Indian GAAP	Ind AS
Framework for accounting for foreign operations	AS-11 is based on the concept of integral and non-integral operations. It therefore provides guidance on what operations are integral and what are not in respect of an enterprise.	Ind AS-21 is based on the concept of functional currency v reporting currency. It therefore provides guidance on what should be the functional currency of an enterprise.
Derivatives and other financial instruments – Cash flow and fair value hedges	No comprehensive guidance except for interim clarification on forward exchange contract to hedge foreign currency risk of a firm commitment or highly probable forecasted transaction	Hedge instruments are measured at fair value. Effective portion of gain/losses on hedges of net investment are recognised in equity and ineffective portion is recorded in income statement

Thank You!