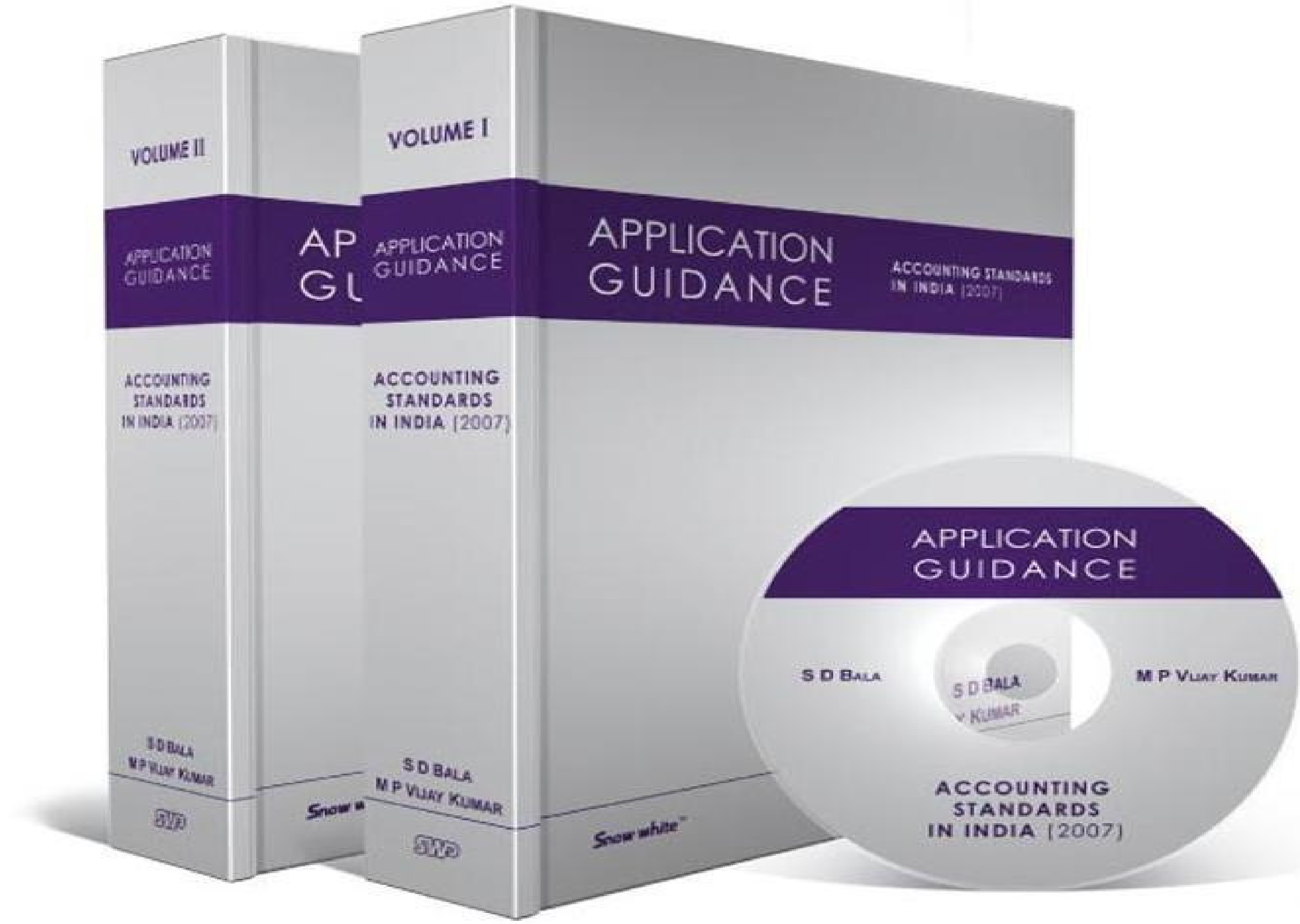

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Salutations to Members of SIRC ICWAI and CBE Branch of SIRC ICWAI

The Effects of Changes in Foreign Exchange Rates

AS 11

The backdrop

- It began in 1976 with a Statement issued by ICAI
- Statement on accounting for foreign currency translation
- In June 1989 (13 years!) ICAI issued a recommendatory Standard
- AS 11 (*Accounting for* the effects of changes in foreign exchange rates)

The backdrop

- 1991 - 1993 : Series of liberalization measurers by RBI – Current account convertibility
- AS 11 was initially intended to be mandatory in 1991 – mandatory application was postponed to 1993
- 1994 : First Revision AS 11 – operative from 1st April 1995

The backdrop

- Developments in the decade between 1993 and 2003
- To bring in greater harmony between domestic and international accounting practices -
- Next Revision AS 11 : 2003 – operative for accounting periods commencing from 1st April 2004

The Standard on Accounting

- In which currency an entity should present its financial statements!
- How to deal with cash flows attributable to foreign operations
- Restatement of financials - convenience presentation – Wockhardt, State Bank of India

Three Parts

- Entity's own transactions
- Transactions relating to Foreign Operations
- Forward Contracts
- Tax effects
- disclosures

- **Accounting for Forex Transactions**

- **When the Standard says Foreign Currency Transactions – the precise implication is, it is a transaction denominated in foreign currency**

- **What if? - - - rupee?**

Transactions denominated in foreign currency

- Income – expense : P & L related
- Asset or Liability: BS related
- Life Cycle of the transaction

Initial Recognition

- Record the transaction in reporting currency
- For this, use the rate applicable at the date of transaction

“at the date of transaction”

- at the date of transaction
- Consider an import
  - Invoice
  - B/Lading
  - Shipment
  - Receipt at port
  - Clearance by clearing agent
  - Rate determined by Customs Authorities?
  - GRN date?

Rate?

- Rate
- Opening rate – 11 AM rate – closing rate for the date - -
- Average rate? –
- Volatility?

High sea sales?

- Transactions of sale or purchase beyond the frontiers of customs

- Transfer of documents of title to goods : from buyer to seller (non negotiable set)?

Service contracts?

- Some of these transactions are complex
- Involving a given time-span in which service will be rendered
- In the given period, billing is done on a mile-stone basis
- Revenue is required to be recognised on a percentage completion basis (date!)

On BS date

- Transactions in respect of which final settlement is yet to be made, will appear as an asset or a liability in BS
- The process of restating the foreign currency denominated items, on BS date is called TRANSLATION
- Classify - Monetary and Non-monetary Items

Monetary items

- **Monetary items** – are moneys held and assets and liabilities to be received or paid in fixed or determinable amounts of money
- Cash, receivables and payables

Non-monetary items

- **Non-Monetary items** – negatively defined other than monetary items
- These are items of liabilities or assets, settlement or recovery of which takes place by delivery and receipt of product or services

Translation on BS date

- **Monetary items – apply closing rate (fair value principle)**
- **Non-Monetary items – if carried at historical cost, then original rate**
- **Non - Monetary items – if carried at fair value, then rate applicable on the date on which fair value was determined**

Closing rate?

- Unrealistic closing rate?
- What is the estimated ‘amount’?

Monetary or non-monetary

- Advance payments – may be revenue items or BS items
- Advance Payments made for purchase of goods or advance payments received for sale of products or services
- Trigger: Transformation from non-monetary to monetary?

- **Export**
- **100 pieces at $ 10 per piece**
- **Along with PO, we get US$ 200 – Rs.45 (9000)**
- **After two months final shipment takes place - revenue ought to be recognised for equivalent of $ 1000 – On that date, rate is 46: What is INR?**

- 46 x 1000 = 46,000
- Or is it enough if we
- 9000 (= 45 x 200) + 36,800 (46 x 800) = 45,800

Exch. Differences arise – in 4 situations

- Transaction and BS date
- BS and settlement date
- Transaction and settlement date
- BS and BS date

Mandatory approach

- **Exchange differences will lead to a gain or loss – to be recognized in the statement of P&L separately**

But is this happening?

- Where the item is imported material
- Exchange losses are added to cost of goods
- Loans advances given to a foreign subsidiary?

Companies (AS) Rules, 2006

- Schedule VI – Capitalisation provisions – **Superseded**
- **Effective 1st April 2007 no Capitalisation**, except to the extent permitted under AS 16

What is permitted under AS 16?

- **Borrowing costs include**
  - **Exchange differences to the extent these are regarded as adjustment to interest cost**
- **How to determine: Extent to which, or the element forming part of the amount of exchange difference – is attributable to borrowing cost?**

Tata Motors – accounting policy

- Transactions in FC are recorded at the exchange rates prevailing on the date of the transaction. FC monetary assets and liabilities are translated at year-end at closing rates. Exchange differences arising on settlement of transactions and translation of monetary items are recognised as income or expense – except --- - - liabilities incurred prior to April 2004, where such exchange difference is adjusted in the carrying cost of FA

A quick recap

- Initial recognition
- BS date translation
- Recognition of Exchange difference
- Schedule VI – AS 16
    - Move on to Part 2

Foreign Operation

- **Activities are <u>based or conducted</u> in a country other than the country of reporting enterprise**
- **Can be a branch, Associate, Joint Venture or a subsidiary**

When IAS 21 arrives: Foreign Operation

- **Activities are based or conducted in a country or currency other than the country of reporting enterprise**

Integral and non-integral

- **Integral: Activities of FO form an integral part (Change in exchange rate affects cash flows of reporting entity)**
- **Non-integral: Negatively defined (Change in exchange rate does not affect cash flows of reporting entity)**

State Bank of India – Accounting Policy

- As Stipulated in AS 11 (Revised 2003), foreign branches of the Bank and Offshore banking units (OBUs) have been classified as Non-integral operations
- Representative offices have been classified as integral operations

Integral

- No difference
- Entity’s (our) own transactions
- Initial Recognition, BS date translation and recognising exchange differences – principles are the same for Integral

Non-Integral

- **Exchange difference is accumulated in Foreign currency Translation Reserve (FCTR)**

Forward Contracts
Hedging or Speculative?

- Forward Contracts: Agreement to exchange currencies at a forward rate
- Hedging contracts – minimise risk in an underlying transaction
- Speculative – seek risk! And if possible make some money

Accounting - Forward Hedge - underlying

- **Cholamandalam Policy:**
  - Premium or discount arising at the inception of the contract (or similar instruments) is amortised as expense or income over the life of the contract

Speculative forward

- **Mark to Market**

Forex – IT Act

- AS – FCL is a monetary item. Exchange differences to be charged to P&L
- IT – Exchange differences if it is attributable to acquisiton of assets can be capitalised with (the relative) asset, on payment basis
- Companies Act – Capitalisation provisions (Schedule VI) since superceded.

Forex - What is in store – IFRS (IAS 21)

- **Notion of reporting currency will be dispensed with**
- **Functional currency (currency of primary economic environment) and presentation currency approach – both for Independent FS and CFS**

Preparedness

- **Determination of functional currency both for Independent FS and for CFS**
- **Initial recording in Functional C.**
- **Exchange differences to P&L**
- **Retranslate Functional currency into Presentation Currency if PC is different**
- **Goodwill on consolidation – IFRS 3**