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IAS 21 The Effects of Changes in Foreign Exchange Rates - A Closer Look

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IAS 21,
The Effects of Changes in Foreign Exchange Rates
- A Closer Look

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International Accounting Standard (IAS) 21, *The Effects of Changes in Foreign Exchange Rates,* prescribes the accounting treatment for the transactions denominated in a foreign currency. In December 1977, the International Accounting Standards Committee (IASC) issued the Exposure Draft E11, *Accounting for Foreign Transactions and Translation of Foreign Financial Statements*. In March 1982, the Exposure Draft E11 was modified and re-exposed as Exposure Draft E23, *Accounting for the Effects of Changes in Foreign Exchange Rates.* In July 1983, the IASC issued IAS 21, *Accounting for the Effects of Changes in Foreign Exchange Rates,* effective from January 1, 1985. In 1993, the IAS 21 (1983) was revised as part of the 'Comparability of Financial Statements' project based on E32. In May 1992, the IASC issued the Exposure Draft E44, *The Effects of Changes in Foreign Exchange Rates*. In December 1993, the IASC issued IAS 21, *The Effects of Changes in Foreign Exchange Rates,* effective from January 1, 1995. On December 18, 2003, the International Accounting Standards Board (IASB) issued the revised version of IAS 21, effective from January 1, 2005. In December 2005, the IASB issued Minor Amendment to IAS 21 relating to net investment in a foreign operation.

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Objective

An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In addition, an entity may present its financial statements in a foreign currency. The objective of IAS 21 is to prescribe the basis for selecting an entity's functional currency and the accounting treatment for the recognition of, and subsequent measurement of, transactions denominated in a foreign currency and the process of translating financial statements denominated in a foreign 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 and Application

IAS 21 applies to:
• Accounting for transactions and balances in foreign currencies except for derivatives within the scope of IAS 39, *Financial Instruments: Recognition and Measurement*
• Translating the results and financial position of foreign operations
• Translating entity's results and financial position into a presentation currency
But IAS 21 does not apply to hedge accounting for foreign currency items and to foreign currency derivatives that are within the scope of IAS 39.
IAS 21 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 (IAS 7, *Statement of Cash Flows*).

Key Definitions

Closing rate is the spot exchange rate at the reporting date**.**
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.
Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
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.
A Group is a parent and all its subsidiaries.
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 report is presented.
Spot exchange rate is the exchange rate for immediate delivery.

Prescribed Accounting Treatment

Transactions

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.

All transactions are recognised in the functional currency of the entity. All currencies other than the functional currency are foreign currencies. A legal or economic entity may have more than one functional currency if it has a foreign operation (subsidiary, associate, joint venture or branch with activities based or conducted in a different country or 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. The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with International Financial Reporting Standards (IFRS). For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

At subsequent reporting dates, any foreign currency denominated monetary items are remeasured using the closing rate. Where any non-monetary items arising from transactions denominated in a foreign currency are subsequently remeasured to fair value, the remeasured amounts are translated using the exchange rate at the date of remeasurement (including remeasurements under IAS 16, *Property, Plant and Equipment*, IAS 38, *Intangible Assets* or IAS 40, *Investment Property).*

The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; and cash dividends that are recognised as a liability. Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: amounts prepaid for goods and services (e.g. prepaid rent); goodwill; intangible assets; inventories; property,

plant and equipment; and provisions that are to be settled by the delivery of a non-monetary asset.

When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.

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 recognised or in previous financial statements are reported in profit or loss in the period, with one 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 recognised, in the consolidated financial statements that include the foreign operation, in a separate component of equity; they will be recognised in profit or loss on disposal of the net investment.

Loan receivable from and payable items to a foreign operation shall be included in the net investment in a foreign operation, if the settlement is neither planned nor likely to occur.

If a gain or loss on a non-monetary item is recognised directly in equity (for example, a property revaluation under IAS 16), any foreign exchange component of that gain or loss is also recognised directly in equity.

Prior to the 2003 revision of IAS 21, an exchange loss on foreign currency debt used to finance the acquisition of an asset could be added to the carrying amount of the asset if the loss resulted from a severe devaluation of a currency against which there was no practical means of hedging. That option was eliminated in the 2003 revision.

Impairment of assets measured in a foreign currency

Some assets are measured at historical cost in a foreign currency and are translated at the exchange rate at the transaction date into the functional currency. Further, all assets are subject to impairment tests such as the recoverable amount test in IAS 36, *Impairment of Assets* and the net realisable value test in IAS 2, *Inventories*. The interaction of these two requirements is that non-monetary assets measured in a foreign currency are assessed for impairment by comparing the following:

- the carrying amount translated at the rate when the carrying amount was determined
- the net realisable value or recoverable amount translated at the rate when that value was determined

The effect of this comparison is that an asset may be impaired in the functional currency but not in the foreign currency or vice versa (since amounts used in impairment testing are translated to the functional currency at current rates, whereas the carrying amount may be translated using historic rates).

Translation

An entity may elect to present its financial report in any currency (referred to as the presentation currency). For this purpose, an entity could be a standalone entity, a parent preparing consolidated financial statements or a parent, an investor or a venturer preparing separate financial statements in accordance with IAS 27, *Consolidated and Separate Financial Statements*. For operations where the functional currency is not the presentation currency, assets and liabilities are translated to the presentation currency using the closing rate at reporting date and income and expenses are translated using the exchange rate at the transaction date. Any resulting exchange difference is recognised as a separate component of equity (e.g. debit or credit to equity). For groups, translation of each entity within the group to the group's presentation currency is performed before preparing the consolidated financial report. A similar process is also adopted in an individual entity's financial report where, for example, there is a branch operation with a different functional currency.

Determination of Functional Currency

The functional currency of an entity depends on the primary economic environment, which is normally the environment in which the entity 'primarily generates and expends cash'.

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

(a) the currency:

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

 (ii) of the main country whose competitive forces and regulations determine the selling 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).

The following may also provide evidence of the functional currency; however the results of these tests do not over-ride the results of the primary factors test:

• the currency in which funds are generated from debt and equity instruments
• the currency in which receipts from operating activities are usually retained
• in determining the functional currency of a foreign operation and whether its functional currency is the same as 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):
— whether its activities are an extension of the reporting entity's activities rather than involving significant 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)

— the proportion of its transactions that are with the reporting entity
— whether its cash flows directly affect those of the reporting entity and are readily distributable to it
— whether its cash flows are sufficient to service its existing and normally expected debt obligations without assistance from the reporting entity.

Disposal of a Foreign Operation

When a foreign operation is disposed of, the cumulative amount of the exchange differences deferred in the separate component of equity relating to that foreign operation shall be recognised in profit or loss when the gain or loss on disposal is recognised.

An entity may dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity. The payment of a dividend is part of a disposal only when it constitutes a return of the investment, for example when the dividend is paid out of pre-acquisition profits. In the case of a partial disposal, only the proportionate share of the related accumulated exchange difference is included in the gain or loss. A write-down of the carrying amount of a foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised in profit or loss at the time of a write-down.

Where the foreign entity reports in the currency of a hyperinflationary economy, the financial statements of the foreign entity should be restated as required by IAS 29, *Financial Reporting in Hyperinflationary Economies*, before translation into the reporting currency.

The requirements of IAS 21 regarding transactions and translation of financial statements should be strictly applied in the changeover of the national currencies of participating Member States of the European Union to the Euro - monetary assets and liabilities should continue to be translated the closing rate, cumulative exchange differences should remain in equity and exchange differences resulting from the translation of liabilities denominated in participating currencies should not be included in the carrying amount of related assets.

Tax Effects of all Exchange Differences

Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. IAS 12, *Income Taxes* applies to these tax effects.

Prescribed Disclosures

Required disclosures include:
• exchange differences recognised in profit or loss (excluding those for financial instruments measured at fair value through profit and loss under IAS 39)
• net exchange differences classified in a separate component of equity, reconciling the amount at the beginning and end of the period
• if the presentation currency is not the functional currency, that fact shall be stated with the disclosure of the functional currency, and the reason for using a different presentation currency
• where there is a change in functional currency, the fact and reason for the change in functional currency shall be disclosed
• when an entity presents its financial statements in a currency that is different from its functional currency, the financial statements shall be described as complying with IFRS only if they comply with all requirements of standards and interpretations

Convenience Translations

Sometimes, 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 simply by translating all amounts at end-of-period exchange rates. This is sometimes called a convenience translation. A result of making a convenience translation is that the resulting financial information does not comply with all IFRS, particularly IAS 21. In this case, the following disclosures are required:

Clearly identify the information as supplementary information to distinguish it from the information that complies with IFRS.

Disclose the currency in which the supplementary information is displayed.

Disclose the entity's functional currency and the method of translation used to determine the supplementary information.

IFRIC Interpretations

The Standards Interpretations Committee (SIC) of the IASC and the International Financial Reporting Interpretations Committee (IFRIC) of the IASB has issued the following Interpretations relating to IAS 21:

- SIC 7, *Introduction of the Euro* (issued in May 1998, effective from June 1, 1998)

- SIC 11, *Foreign Exchange – Capitalisation of Losses Resulting from Severe Currency Devaluations* (SIC 11 was superseded and incorporated into the 2003 revision of IAS 21)

- SIC 19, *Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29* (SIC 19 was superseded and incorporated into the 2003 revision of IAS 21)

- SIC 30, *Reporting Currency – Translation from Measurement Currency to Presentation Currency* (SIC 30 was superseded and incorporated into the 2003 revision of IAS 21)

- IFRIC 16, *Hedge of a Net Investment in a Foreign Operation* (issued in July 3, 2008, effective from October 1, 2008)

SIC 7

SIC 7 addresses how the introduction of the Euro, resulting from the European Economic and Monetary Union (EMU), affects the application of IAS 21. SIC 7 states that the requirements of IAS 21 should be strictly applied when a country joins the EU's Economic and Monetary Union. Therefore:

foreign currency monetary assets and liabilities resulting from transactions continue to be translated into the functional currency at the closing rate. Any resulting exchange differences are recognised as income or expense immediately, except that an entity continues to apply its existing accounting policy for exchange gains and losses related to hedges of the currency risk of a forecast transaction;

cumulative exchange differences relating to the translation of financial statements of foreign operations continue to be classified as equity and are recognised as income or expense only on the disposal of the net investment in the foreign operation; and

exchange differences resulting from translating liabilities denominated in participating currencies are not included in the carrying amount of related assets.

IFRIC 16

IFRIC 16 clarifies three main issues:

(i) Whether risk arises from (a) the foreign currency exposure to the functional currencies of the foreign operation and the parent entity, or from (b) the foreign currency exposure to the functional currency of the foreign operation and the presentation currency of the parent entity's consolidated financial statements. IFRIC 16 concludes that the presentation currency does not create an exposure to which an entity may apply hedge accounting. Consequently, a parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between its own functional currency and that of its foreign operation.

(ii) Which entity within a group can hold a hedging instrument in a hedge of a net investment in a foreign operation and in particular whether the parent entity holding the net investment in a foreign operation must also hold the hedging instrument. IFRIC 16 concludes that the hedging instrument(s) may be held by any entity or entities within the group.

(iii) How an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item when the entity disposes of the investment. IFRIC 16 concludes that while IAS 39 must be applied to determine the amount that needs to be reclassified to profit or loss from the foreign currency translation reserve in respect of the hedging instrument, IAS 21 must be applied in respect of the hedged item.

At its January 2009 Meeting, the IASB discussed an issue that had been submitted by a constituent subsequent to the publication of IFRIC 16. The staff had satisfied itself (in consultation with IASB members and an IFRIC member) that the constituent's issue was valid and had not been contemplated by the IFRIC when IFRIC 16 was being developed. The concern raised was that in some circumstances, while the total amounts of foreign exchange differences are indeed the same with and without hedge accounting, the split between the amounts included in profit or loss and foreign currency translation reserve would be different. Without hedge accounting, the foreign exchange difference arising from the hedging instrument would be included in profit or loss while the difference arising from the net investment would be included in the foreign currency translation reserve.

Based on discussions at its January 2009 Meeting, on January 30, 2009 the IASB issued Exposure Draft ED/2009/1 proposes to amend IFRIC 16 paragraph 14 by deleting a parenthetical comment: '(except the foreign operation that itself is being hedged)'.

On April 16, 2009 the IASB amended IFRIC 16 to allow entities to designate as a hedging instrument in a net investment in a foreign operation an instrument that is held by the foreign operation that is being hedged. Effective date is July 1, 2009. The amendment was part of the IASB's annual improvements for 2009.

Minor Amendment to IAS 21 – Net Investment in a Foreign Operation

In June 2005 Meeting, the IASB discussed whether different accounting treatments should apply to exchange differences on monetary items denominated in different currencies. The IASB also discussed whether funding provided to a foreign operation by a group entity that is not the reporting entity may be considered to be part of the reporting entity's net investment in that foreign operation in the context of paragraph 32 of IAS 21.

The IASB agreed that the intention should be to treat third-currency denominated monetary items that form a part of the net investment in a foreign operation similar to when the monetary item is denominated in the functional currency of either the reporting entity or the foreign operation.

The staff proposed to delete paragraph 33 of IAS 21 in order to remove the inconsistency. However the IASB indicated a preference to delete only the last two sentences of that paragraph and include additional guidance. The IASB agreed that the ability to account for exchange differences in equity as provided for by paragraph 32 of IAS 21 should only be available where the lender is in a control relationship (i.e. parent or subsidiary lends to a foreign operation). Monetary amounts outstanding between fellow subsidiaries would qualify for equity treatment, but this would not extend to trade receivables or trade payables. Some IASB members expressed concern whether the above amendment is not sufficiently restrictive to limit its application to a situation where the lender is in a control relationship.

At its November 2005 meeting, the IASB approved certain amendments to IAS 21 that had been proposed in Draft Technical Correction (DTC) 1 *Proposed Amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates – Net Investment in a Foreign Operation*. However, the IASB also decided not to pursue further Technical Corrections but, instead, to adopt editorial corrections as fast-track amendments. The IAS 21 amendment was issued December 15, 2005.

The amendment responds to concerns expressed by the IASB's constituents earlier this year that IAS 21 as amended in December 2003 required different accounting depending on the currency in which a monetary item was denominated where such an item was regarded as part of an entity's investment in a foreign operation. Secondly, IAS 21 was not clear on whether any member of a consolidated group could enter into the monetary transaction with the foreign operation. In response to those concerns, the IASB reviewed IAS 21 and reached the following decisions, which are reflected in the amendment:

As regards a monetary item that forms part of an entity's investment in a foreign operation, the IASB concluded that the accounting treatment in consolidated financial statements should not be dependent on the currency of the monetary item.

Also, the accounting should not depend on which entity within the group conducts a transaction with the foreign operation.

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 21 is AS 11, *The Effects of Changes in Foreign Exchange Rates.* The major differences between these two standards are difference due to level of preparedness:

1. AS 11 is based on the integral and non-integral foreign operations approach, i.e., the approach which was followed in the earlier IAS 21 (revised 1993).
2. The current IAS 21, which is based on ‘Functional Currency’ approach, gives similar results as that under pre-revised IAS 21, which was based on integral /non-integral foreign operations approach. Accordingly, there are no significant differences between IAS 21 and AS 11.

Indian companies, which were hit by both the rapid appreciation and depreciation of foreign currencies, had demanded for the suspension of the provisions of AS 11 that require recognizing foreign exchange losses in the financial statements. The Confederation of Indian Industry (CII), the Federation of Indian Chambers of Commerce and Industry (FICCI) and ASSOCHAM have been demanding the postponement of the implementation of AS 11 because several companies with foreign exchange earnings will have to take a hit on their profits because the rupee has depreciated by over 25% in the past one year.

On March 24, 2009, the National Advisory Committee on Accounting Standard (NACAS) has postponed the implementation of AS 11 to 2011 after the conclusion of the meeting to take up the matter of how companies should account for foreign exchange losses or gains caused by a wildly swinging Rupee.

On March 31, 2009, the Ministry of Corporate Affairs (MCA) notified in the Official Gazette, the Companies (Accounting Standards) Amendment Rules, 2009 [G.S.R. 225 (E)] for introducing an additional paragraph 46 to AS 11. The rules provide the following amendment:

In the Companies (Accounting Standards) Rules, 2006, in the Annexure, under the heading “B. ACCOUNTING STANDARDS”, in the sub-heading “Accounting Standard (AS) 11” relating to “The Effects of Changes in Foreign Exchange Rates”, after paragraph 45, the following shall be inserted, namely:—

“46. In respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011, at the option of the enterprise (such option to be irrevocable and to be exercised retrospectively for such accounting period, from the date this transitional provision comes into force or the first date on which the concerned foreign currency monetary item is acquired, whichever is later, and applied to all such foreign currency monetary items), exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a “Foreign Currency Monetary Item Translation Difference Account” in the enterprise’s financial statements and amortized over the balance period of such long-term asset/liability but not beyond 31st March, 2011, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with paragraph 15. For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously recognized in the profit and loss account before the exercise of the option shall be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to “Foreign Currency Monetary Item Translation Difference Account” in both cases, by debit or

credit, as the case may be, to the general reserve. If the option stated in this paragraph is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

The above amendment shall be applicable to corporates registered under the Companies Act, 1956 and all non-corporate entities, partnership or otherwise, are still expected to comply with AS 11 as pronounced by the ICAI.

Conclusion

AS 11 dealt with mark-to-market provisioning in corporate profit and loss accounts for foreign exchange related gains and losses. The suspension of AS 11 results domestic firms have the option not to provide for foreign exchange losses or gains till 2011. The postponement of AS 11 to 2011 raises serious questions about the India's convergence with IFRS in 2011.

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