

# FOREIGN EXCHANGE COMPLEXITIES

15 DECEMBER 2021



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# AGENDA

1. Introduction - Scope and Objective of IAS 21
2. Determining Functional Currency
3. Reporting Foreign Currency Transactions in the Functional Currency
4. Translation of a Foreign Operation
5. Use of a Presentation Currency other than the Functional Currency
6. Disclosures



# INTRODUCTION

# IAS 21 - SCOPE AND OBJECTIVE

How to report the effects of changes in exchange rates in financial statements arising from...

Transactions  
denominated in a  
foreign currency

Interests in  
foreign  
operations

Translation of  
financial  
statements into a  
foreign currency

# IAS 21 - SCOPE AND OBJECTIVE

Transactions denominated in a foreign currency

Presentation currency is different from the functional currency

Functional currency is different from the currency of the jurisdiction in which the entity is domiciled

Progressively increasing number of significant transactions in a foreign currency

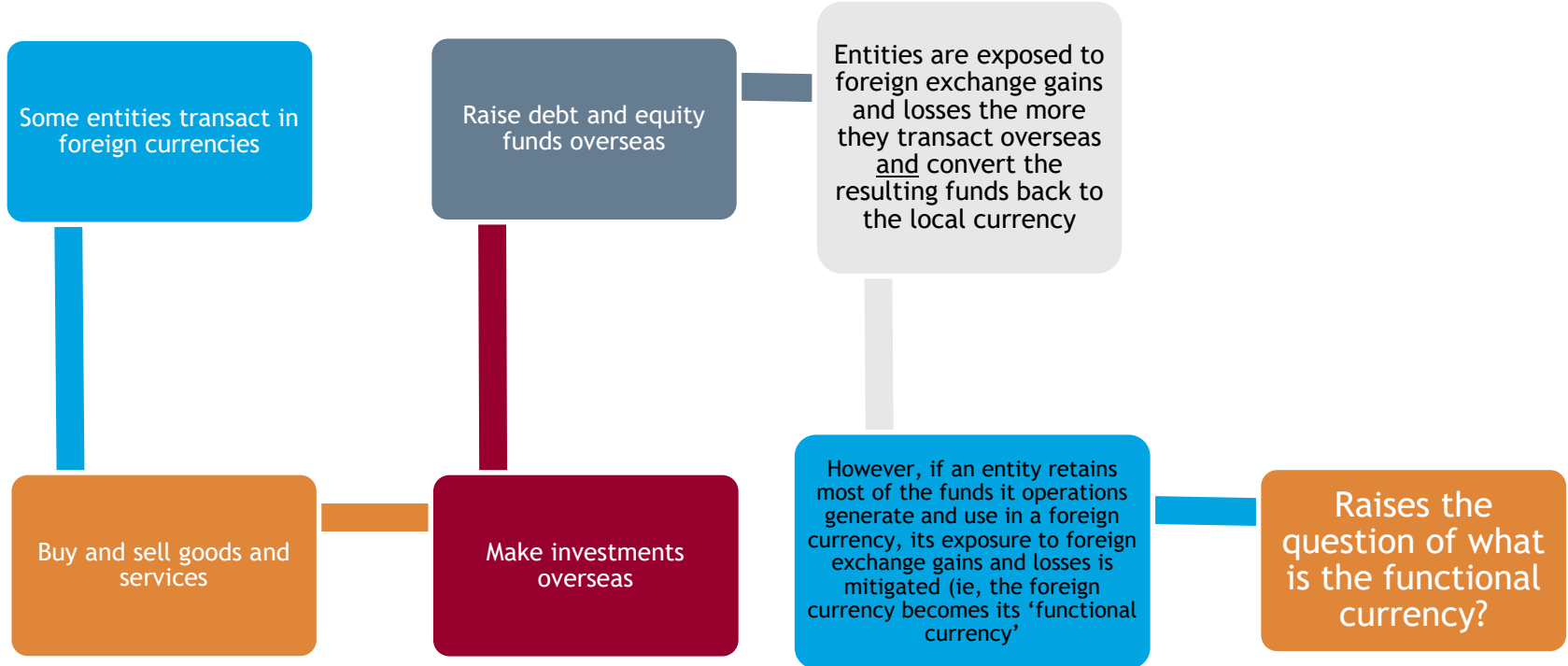
Progressively increasing number of investors located in a foreign jurisdiction





# DETERMINING FUNCTIONAL CURRENCY

# DETERMINING FUNCTIONAL CURRENCY - WHY IS IT IMPORTANT?



# DETERMINING FUNCTIONAL CURRENCY

Definition (IAS 21.9)

“Currency of the primary economic environment in which the entity operates”

= Currency in which the entity generates & expends cash

# DETERMINING FUNCTIONAL CURRENCY

## Step 1

Consider the **primary indicators** of functional currency (IAS 21.9)

## Step 2

Consider the **additional supporting indicators** (IAS 21.10)

## Step 3

Consider **additional supporting indicators** of functional currency of foreign operation (IAS 21.11)

## Step 4

When indicators are mixed and functional currency is not obvious, use **judgement** (IAS 21.12)

# DETERMINING FUNCTIONAL CURRENCY

## Step 1 - Consider the primary indicators of functional currency (IAS 21.9)

- ▶ What mainly influences sales prices for goods & services?
- ▶ The country whose competitive forces and regulations mainly determine the sales price?
- ▶ What mainly influences labour, material and other costs of providing goods and services?

# DETERMINING FUNCTIONAL CURRENCY

If it is obvious what the functional currency is from applying the primary indicators ,



There is **NO** need to consider additional supporting indicators

# DETERMINING FUNCTIONAL CURRENCY

## Step 2 - Consider the additional supporting indicators (IAS 21.10)

- ▶ In which funds from **financing activities** are generated?
  - E.g. issuing debt and equity instruments
- ▶ The currency in which receipts from **operating activities** are usually retained?

# DETERMINING FUNCTIONAL CURRENCY

## Step 3 - Consider additional supporting indicators of functional currency of foreign operation (IAS 21.11)

- ▶ Activities carried out as an extension of reporting entity
  - No significant degree of autonomy
- ▶ Transactions with the reporting entity = high or low proportion of the foreign operation's activities
- ▶ Cash flows of the foreign operation directly affect the cash flows of the reporting entity
- ▶ Cash flows of the foreign operation sufficient to service existing & expected debt obligations without funds from reporting entity



# DETERMINING FUNCTIONAL CURRENCY

**Step 4 - When indicators are mixed or function currency is not obvious, use judgement (IAS 21.12)**

- ▶ Management uses its **judgement** to determine the functional currency that **most faithfully represents the economic effects** of the underlying transactions, events and conditions when:
  - the indicators are **mixed**; and
  - the functional currency is **not obvious**

# DETERMINING FUNCTIONAL CURRENCY

## Important considerations:

- ▶ EACH entity determines its own functional currency (IAS 21.17)
  - as a stand-alone entity
  - as an entity with foreign operations (such as a parent) or
  - as a foreign operation (such as a subsidiary or branch)
- ▶ NOTE: functional currency of the parent may differ from functional currency of operating subsidiary
- ▶ IAS 21 does NOT require an entity to consider local, statutory and tax requirements when determining its functional currency

# DETERMINING FUNCTIONAL CURRENCY

## Change of functional currency (IAS 121.13)

- ▶ An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it
- ▶ Once determined, it is **NOT** changed **UNLESS** there is a change in those underlying transactions, events and conditions
- ▶ **THE ISSUE**
  - What constitutes a change in the underlying transactions, events and conditions?

# DETERMINING FUNCTIONAL CURRENCY

## Change of functional currency (IAS 121.13)

Apply the translation procedures applicable to the new functional currency  
**prospectively** from the date of the change



i.e. Translate all items into NEW functional currency using exchange rate  
**at the date of the change**



# REPORTING FOREIGN CURRENCY TRANSACTIONS IN THE FUNCTIONAL CURRENCY

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

- ▶ **Translating into functional currency**
  - Initial recognition
  - Subsequent reporting
- ▶ **Recognition of exchange differences**
- ▶ **Disclosures**

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## Examples of foreign currency transactions

- ▶ Buy or sell goods in €
- ▶ Incur or settle liabilities in US\$
- ▶ Acquire or dispose assets in £
- ▶ Borrow or lend funds in ¥

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## Initial Recognition (IAS 21.21)

Foreign currency amount

x

Spot exchange rate

@

Date of the transaction



# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

Date of transaction (IAS 21.22)

= date transaction **FIRST** qualifies for recognition

Eg: date entity obtains control of asset or meets revenue recognition criteria

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## Exchange differences:

FOB destination

- ▶ Seller incurs delivery expense
- ▶ Title passes at destination

FOB shipping point

- ▶ Buyer incurs delivery expense
- ▶ Title passes at shipping point

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

Subsequent reporting dates (IAS 21.23)

**Monetary items**  
@ closing rate

**Non-monetary items at historical cost**  
@ rate on date of transaction

**Non-monetary items at FV**  
@ rate on date FV determine

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

MONETARY ITEMS = “units of currency held and asset & liabilities to be received or paid in a fixed or determinable number of units of currency”

- ▶ = right to receive / obligation to deliver
  - a fixed or determinable number of units of currency
  - = items which represent a FIXED amount of foreign currency units
- ▶ Examples:
  - Debtors
  - Cash
  - Pensions & other employee benefits to be settled in cash
  - Provisions to be settled in cash

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## NON-monetary items

- ▶ = **LACK** the right to receive / obligation to deliver  
a fixed or determinable number of units of currency  
= Items whose value is not permanently determined
- ▶ Examples:
  - Goodwill
  - Intangible assets
  - Provisions to be settled by delivery of non-monetary assets
  - PPE
  - Inventories

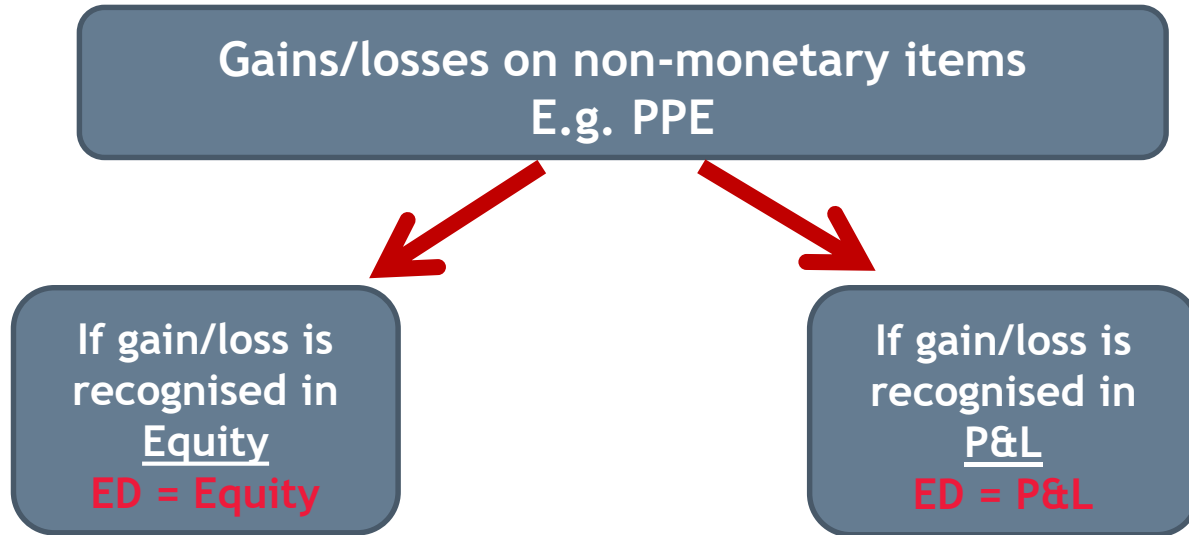
# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## Subsequent reporting dates (IAS 21.23)

- ▶ How do we translate:
  - PPE measured at FV ?
  - PPE measured at historical cost ?
  - Inventory (lower of cost and NRV) ?

# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## Recognition of exchange differences (IAS 21.30)



# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## Subsequent reporting dates (IAS 21.23)

What about impaired assets ????

- ▶ Non-monetary asset measured in a FC
  - ▶ Compare:
    - Cost/carrying amount @ rate on date amount was determined (eg: historical rate)
    - NRV / RA @ closing rate
- = Impairment loss



# REPORTING FOREIGN CURRENCY TRANSLATIONS IN THE FUNCTIONAL CURRENCY

## Recognition of exchange differences (IAS 21.28)

Settlement of monetary items  
= profit or loss

- ▶ Exchange difference = change in rate from:
  - Transaction date
  - Reporting date
  - Settlement date



# TRANSLATION OF A FOREIGN OPERATION



# NET INVESTMENT IN A FOREIGN OPERATION (IAS 21.15 & 44-49)

Exchange differences on monetary item that forms part of net investment in Foreign operation (FO)

# NET INVESTMENT IN A FOREIGN OPERATION (IAS 21.15 & 44-49)

- ▶ Net Investment in Foreign Operation =
  - “amount of reporting entity’s interest in net assets of that operation”
- ▶ Foreign Operation =
  - “a **subsidiary, associate, JV or branch** of a reporting entity; &
  - the **activities** are based in a country or **currency** other than those of reporting entity”
  - Eg: FO = US\$ and RE = AU\$

# NET INVESTMENT IN A FOREIGN OPERATION (IAS 21.15 & 44-49)

- ▶ If entity has **monetary item** that is:
  - Neither planned or likely to be settled in foreseeable future
- ▶ **Example** of monetary item:
  - Long term loan/receivable
  - ≠ trade receivables or payables
- ▶ **IN SUBSTANCE** = part of entity's net investment in FO

# NET INVESTMENT IN A FOREIGN OPERATION (IAS 21.15 & 44-49)

## EXAMPLE

An entity (Entity A) has a subsidiary (Sub X)

Entity A grants a loan to Sub X

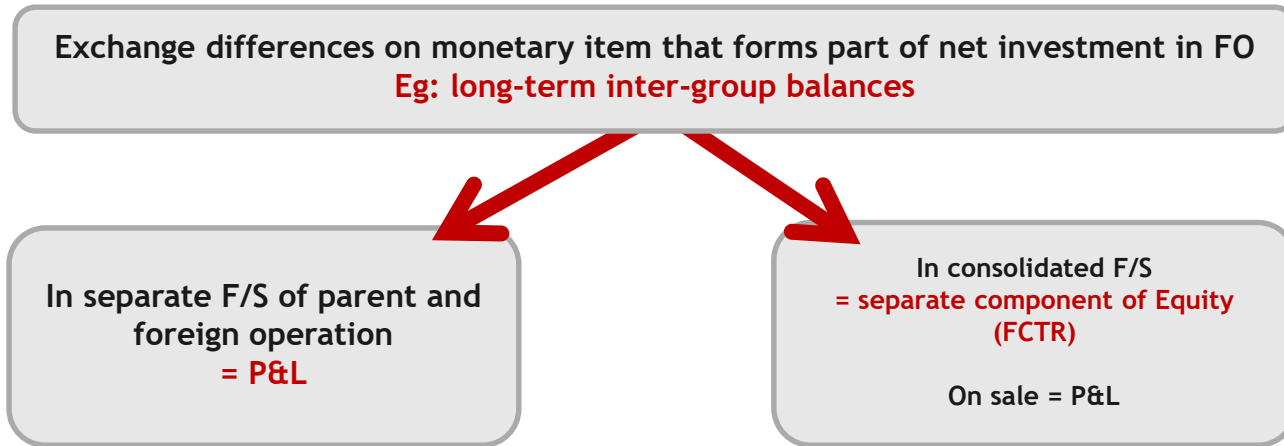
Loan receivable from Sub X = part of net investment in Sub X ONLY if....



Settlement of the loan is neither planned nor likely to occur in the foreseeable future

# NET INVESTMENT IN A FOREIGN OPERATION (IAS 21.15 & 44-49)

## Recognition of exchange differences (IAS 21.32)



# PRESENTATION CURRENCY (IAS 21.38-43)



# PRESENTATION CURRENCY (IAS 21.38-43)

An entity may present its financial report in ANY currency  
If functional currency  $\neq$  presentation currency



Translate results into presentation currency

# THE MATHS OF FOREIGN CURRENCY TRANSLATION

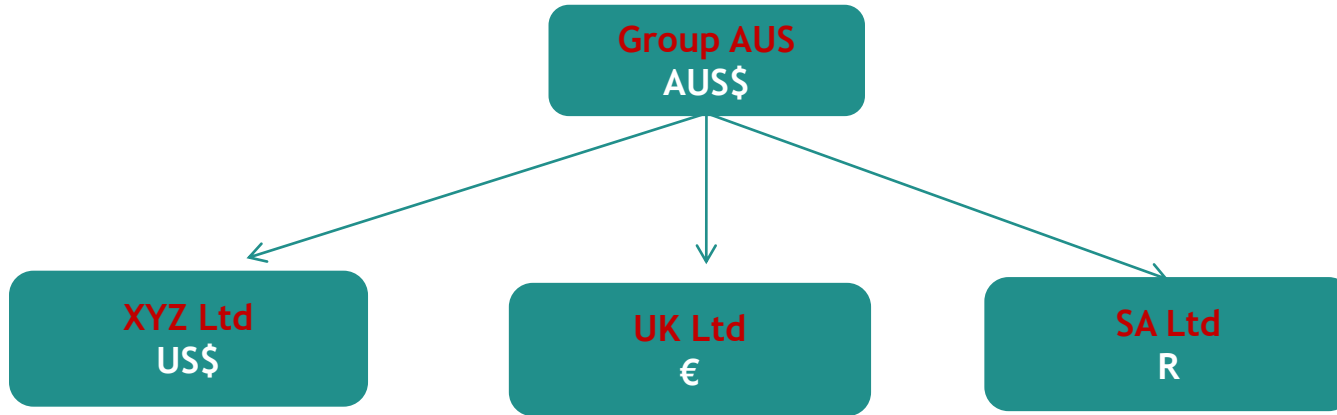
	\$USD	Rate	\$AUD
Revenues	100	0.80	125
Expenses	<u>(80)</u>	0.80	<u>(100)</u>
Profit	20		25
Opening retained profits	<u>40</u>	0.80	<u>50</u>
Closing retained profits	60		75
Assets	(200)	0.80	(250)
Liabilities	140	0.80	175

# THE MATHS OF FOREIGN CURRENCY TRANSLATION

	\$USD	Rate	\$AUD
Revenues	100	0.80	125
Expenses	<u>(80)</u>	0.80	<u>(100)</u>
Profit	20		25
Opening retained profits	<u>40</u>		<u>50</u>
Closing retained profits	60		75
Assets	(200)	0.75	(267)
Liabilities (monetary)	140	0.75	<u>187</u>
Difference			(5)

# PRESENTATION CURRENCY (IAS 21.38-43)

Example of functional currency  $\neq$  presentation currency



Functional currency differs across group  
Presentation currency of group = AUS\$  
Translate various functional currencies to AUS\$ =  
Presentation currency

# PRESENTATION CURRENCY (IAS 21.38-43)

## Translating into presentation currency

- ▶ Assets/Liabilities @ closing rate
- ▶ Income/Expenses @ exchange rate on transaction date = Average rate
- ▶ Exchange differences be recognised in equity
  - Why in Equity and NOT P&L?
  - The changes in exchange rates have little or no direct effect on the present and future cash flows from operations. It is only for presentation purposes and therefore should not impact P&L.

# PRESENTATION CURRENCY (IAS 21.38-43)

## Hyperinflationary economies

Countries with 3-year cumulative inflation rates exceeding 100%

- ▶ Argentina
- ▶ Iran
- ▶ Lebanon
- ▶ South Sudan
- ▶ Sudan
- ▶ Venezuela
- ▶ Zimbabwe

# PRESENTATION CURRENCY (IAS 21.38-43)

## Hyperinflationary economies

- ▶ If entity's functional currency = hyperinflationary
  - Restate Financial Statements in accordance with AASB 129 BEFORE applying translation method in IAS 21.42
  - **ALL amounts @ closing rate**
  - **Comparative amounts**
    - NOT adjusted for:
    - Subsequent changes in price levels
    - Subsequent changes in exchange rates



# DISCLOSURES



# DISCLOSURES

## Disclosures (IAS 21.51-57)

- ▶ Amount of exchange differences recognised in **profit or Loss** (except for those arising on financial instruments measured at FVTPL under AASB 9 - included in fair value measurement)
- ▶ Net exchange differences recognised in OCI and accumulated in a separate component of equity ('Foreign Currency Translation Reserve'), including a reconciliation of the amount of exchange differences at the beginning and end of period

# DISCLOSURES

## Disclosures (IAS 21.51-57)

- ▶ When the **presentation currency** ≠ **functional currency**, disclose:
  - the **fact**, and
  - the **reason** for using different presentation currency
- ▶ When there is a **change in functional currency** of either the reporting entity or a significant foreign operation, disclose:
  - the **fact**, and
  - the **reason** for the change

## Disclosures (AASB 101.51(d))

- ▶ Disclose the **presentation currency** used, as defined in IAS 21

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