TEN WAYS TO MATERIALLY MISSTATE YOUR FINANCIAL STATEMENTS…THE 'BLIND FREDDY' PROPOSITION CONTINUED - PART FIVE – FUNCTIONAL CURRENCY

THIS MONTH WE CONTINUE OUR 'BLIND FREDDY' SERIES WITH A DISCUSSION ON FUNCTIONAL CURRENCIES AND HOW EASY IT IS TO GET THEM WRONG.

AASB 121 *The Effects of Changes in Foreign Exchange Rates* includes a hierarchy of indicators within paragraphs 9-12 that establish an entity's functional currency as follows:

Paragraph 9

'The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

a. The currency:
   (i) That mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled)
   (ii) Of the country whose competitive forces and regulations mainly determine the sales price 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).'

Paragraph 10

'The following factors may also provide evidence of an entity's functional currency:

a. The currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated;
b. The currency in which receipts from operating activities are usually retained.'

Paragraph 12

'When the above indicators are mixed and the functional currency is not obvious, management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, management gives **priority** to the primary indicators in paragraph 9 before considering the indicators in paragraphs 10 and 11, which are designed to provide additional supporting evidence to determine an entity's functional currency.'

This hierarchy explicitly gives more importance to paragraph 9 of the standard than paragraph 10. If an entity's revenues and costs associated with generating those revenues are impacted by US dollar (USD) movements, this is more significant when determining the entity's functional currency than the entity's funding arrangements.

Therefore, an Australian parent company, with the majority of its revenue earning activity being by way of dividends received from its overseas subsidiaries, is very unlikely to have an Australian dollar (AUD) functional currency.

In the case of a mining operation, it is possible that the functional currency of both the overseas subsidiary and the Australian parent company will change over the course of the exploration/mining activity of the overseas subsidiary, regardless of the way the group is funded.

During the exploration and evaluation (E&E) phase, there will be no revenue from the operation, so the most important issue to consider is the nature of the costs being incurred. It may be the case that expatriate salaries are being paid in AUD, equipment is being sourced in AUD and drilling contracts are being negotiated and priced in AUD. In such circumstances AUD would appear to be the functional currency of both the overseas subsidiary and the parent company.

Once the development phase is reached, it is likely that the nature of the costs being incurred by the overseas entity change and are either likely to be in local currency or in USD. At this stage, we therefore need to reassess what the functional currency of both the overseas subsidiary and the parent company should be.

When the overseas operation enters the production phase, this revenue is most likely to be influenced by USD movements as dividend income from the overseas subsidiary is the parent company's major source of revenue. It is most likely that the functional currency of both the overseas subsidiary and the Australian parent company is USD.

A similar situation arises when a group's manufacturing and sales activities are located overseas, e.g. in China or SE Asia.

Material errors arise mainly when an entity elects to hold AUD for commercial reasons, either for security, waiting to pass moneys overseas for expenditure on E&E, development, etc., or when an entity intends to pay dividends to Australian shareholders. Any balance held in AUD gives rise to a foreign exchange gain or loss, depending on the movement between AUD and the entity's functional currency.

Example – Functional Currency

Australia Limited is listed on the ASX and its shares are quoted in AUD. Its only business is a mine in West Africa, operated by African Subsidiary Pte. The African subsidiary mines gold, sold in USD, pays its expatriate work force in USD, and purchases most of its mining equipment in USD. The Australian head office is a small operation, supporting the Australian board and fund raising. The group is 100 percent funded through Australian shares listed on the ASX.

- Australia Ltd raises $10 million on the ASX on 1 January 2012
- It retains $10 million in a 'safe' AUD bank account
- Exchange rate at 1 January 2012 is AUD 1:USD 1.1
- Exchange rate at 30 June 2012 is AUD 1:USD 0.7
- Group's presentation currency is AUD.

Australia Limited wrongly concludes that because it is listed on the ASX and funded entirely in AUD that the functional currency of the Australian parent company is AUD.

Due to the strengthening of the USD against the AUD, the value of the AUD bank account has fallen significantly in US dollar terms. This is because Australia Limited has wrongly identified AUD as its functional currency.

The proposed accounting in AUD presentation currency is as follows:

	Parent Co	Group
Cash	$10m	$10m
FX loss	zero	zero

The correct accounting in Australia Limited's USD functional currency is:

Translate into USD at AUD 1: USD 1.1	USD $11,000,000
Translate into USD at AUD 1:USD 0.7	USD $7,000,000
FX loss in USD	USD $4,000,000

This is then reflected in Australia Ltd's AUD presentation currency as follows:

	Parent Co	Group
Cash	$10m	$10m
FX Loss	$5.714m	$5.714
FX Reserve	($5.714m)	($5.714m)

In next month's newsletter we will discuss business combination issues that can give rise to material misstatements.