

# IAS 21 – The Effects of Changes in Foreign Exchange Rates



## CA Rajkumar S Adukia

B.Com (Hons), FCA, ACS, ACWA,  
LLB, DIPR, DLL &LP, IFRS(UK),  
MBA

email id: [rajkumarradukia@caaa.in](mailto:rajkumarradukia@caaa.in)

Mob: 09820061049/09323061049

To receive regular updates kindly send test email to : [rajkumarfca-subscribe@yahoogroups.com](mailto:rajkumarfca-subscribe@yahoogroups.com) & [rajkumarfca+subscribe@googlegroups.com](mailto:rajkumarfca+subscribe@googlegroups.com)

# Effective Date and Application of this Standard

- An entity shall apply this standard for annual periods beginning on or after 1st January 2005
- This Standard supersedes IAS 21 – The Effects of Changes in Foreign Exchange Rates ( Revised in 1993)
- Also relevant are SIC -7 Introduction of the Euro and IFRIC 16 – Hedges of a Net Investment in a Foreign Operation

# Corresponding Standards

- Corresponding standard in US GAAP:  
FAS 52: Foreign Currency Translation
- In Indian GAAP:
  - AS 11
  - Ind AS 21 The Effects of Changes in Foreign Exchange Rates

# 3 Aspects of IAS 21

- Foreign Operation
- Foreign Currency Transaction
- Presentation of Financial Statements in Foreign Currency

# Objective of IAS 21

- Prescribing rules to include FCT and FO in the FS of an entity
- Translating FS into Presentation Currency

# Principal Issues

- Which Exchange Rate to Use??
- How to report the Effects of Changes in Exchange Rates in the FS

# Application of the Standard

- **In Accounting** – Transactions and Balances in FCs ( except derivative transactions and balances covered under **IFRS 9**)
- **In Translating** – Results and Financial Position of FOs ( included in the FS of the entity by Consolidation)
- **In Translating** – Results and Financial Position of the Entity – Into Presentation Currency

# Exclusion

- FC Derivatives ( IFRS 9) excluded from the scope of IAS 21
- Hedge Accounting for FC Items and Hedging of Net Investment in FO ( NI in FO) excluded
- Does not apply to presentation in a Statement of Cash Flow of Foreign Currency Transaction or Translation of CFs from FOs ( IAS 7 Cash Flow Statements)



# **IFRIC 16: Hedges of a Net Investment in a Foreign Operation**

It clarifies three main issues:

- 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.

# **IFRIC 16: Hedges of a Net Investment in a Foreign Operation**

- the hedging instrument(s) may be held by any entity or entities within the group except the net investment itself.
- 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.

# Important Terminologies – IAS 21 Para 8

- Closing Rate
- Exchange Difference
- Exchange Rate
- Fair Value
- Foreign Currency
- Foreign Operation
- Functional Currency
- Group
- Monetary Items
- Net Investment in a Foreign Operation
- Presentation Currency
- Spot Exchange Rate

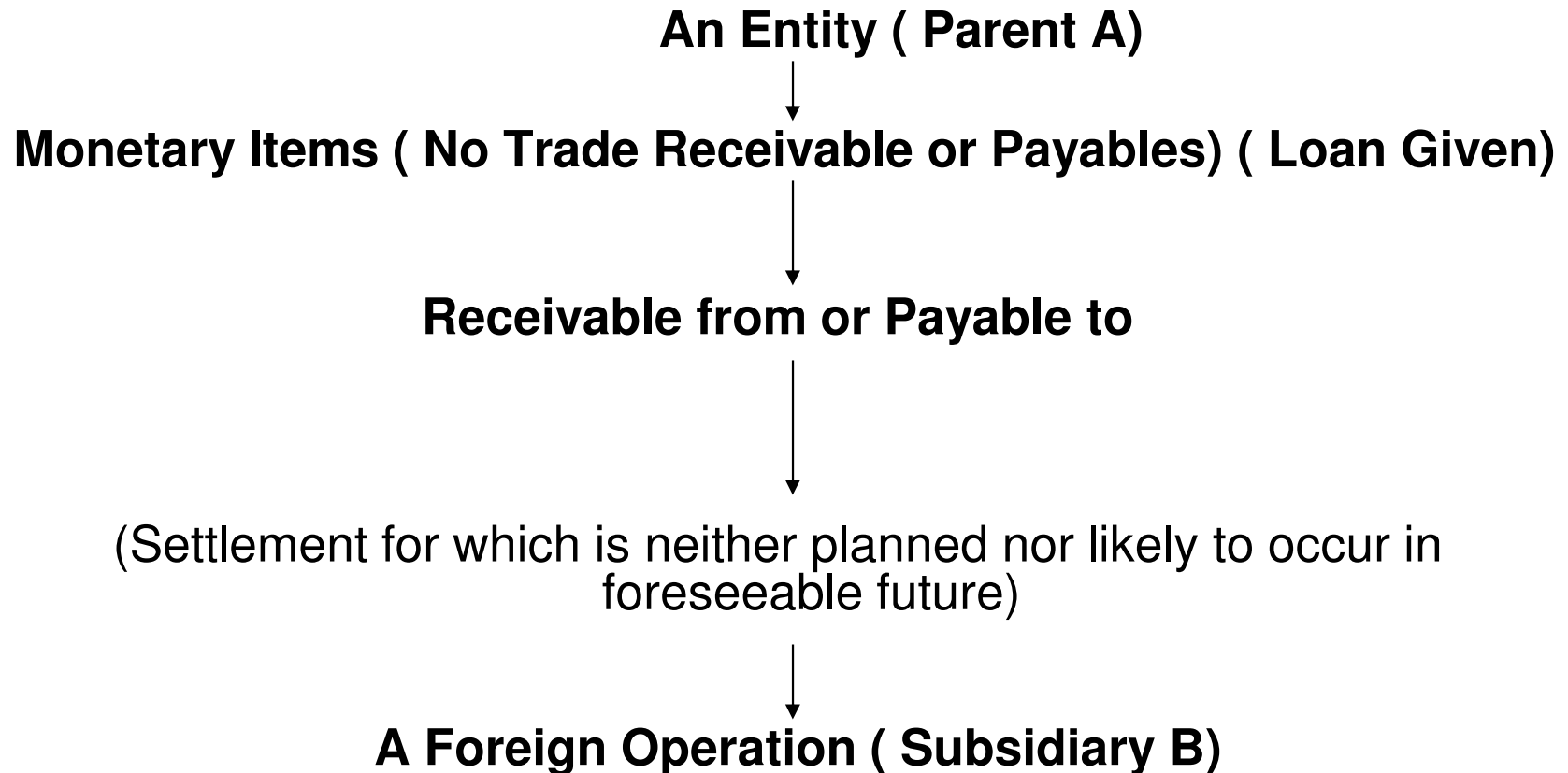
# Foreign Operation

- **Foreign Operation - is an entity that is a**

- A Subsidiary
- An Associate
- A Joint Venture
- A Branch

of the **Reporting Entity**

# Net Investment in a Foreign Operation



# Monetary Items

It is a right to receive a fixed or determinable number of units of a currency

- Eg., Pension and Other employee benefits to be paid in Cash
- Provisions that are to be settled in Cash
- Cash dividends that are recognized as liabilities

# Non Monetary Items

Absence of right to receive a fixed or determinable number of units of a currency

- Eg., Prepaid rent
- Goodwill
- Intangible Assets
- Inventories
- PPE

# Approach of IAS 21

- Determination of Functional Currency
- Translation of FC Items into Functional Currency and reporting the effects of translation
- Translation of Results and Financial Position of an individual entity within the Reporting Entity whose Functional Currency differs from the Presentation Currency should be translated



# Reporting Foreign Currency Transactions in Functional Currency

- **Nature of FC Transactions**
  - Buying and Selling of Goods or Services – Price denominated in FC
  - Borrowing or Lending of Funds – When amounts Payable or Receivable – Denominated in FC
  - Acquiring or Disposing of assets – Denominated in FC or Incurring or Settling of Liabilities – Denominated in FC

# Reporting Foreign Currency Transactions in Functional Currency

- **Initial Recognition**

- *Step 1:* Apply Spot Exchange Rate between Foreign Currency and Functional Currency
- *Step 2:* As on the Date of Transaction ( date on which it qualifies for recognition under IFRS)
- *Step 3:* On the Foreign Currency Amount

# Reporting Foreign Currency Transactions in Functional Currency

- **Reporting at the ends of Subsequent Reporting Periods**

At the end of every reporting period

- FC Monetary Items translated – using Closing Rate
- Non Monetary Items – measured using Historical Cost in FC – translated at Ex Rate at the date of the Transaction

# Reporting Foreign Currency Transactions in Functional Currency

- Non Monetary Items – measured using Fair Value in FC – translated at Ex Rate at the date when FV was determined
- ( Determination of HC or FV depends on IAS 16 where the item is PPE)
- ( Determination of lower of Cost or NRV as per IAS 2 where it is inventory)
- ( Determination of lower of carrying amount or recoverable amount depends on IAS 36 Impairment of Assets where assets are subject to impairment)

# Reporting Foreign Currency Transactions in Functional Currency

## Recognition of Exchange Differences

Exchange Differences arises

- On settlement of Monetary Items or
- Translating Monetary Items at rates different from that of Initial Recognition – during the period or in previous financial statements

# **Reporting Foreign Currency Transactions in Functional Currency**

## **Treatment of Exchange Difference**

- Shall be recognized in P&L

# Reporting Foreign Currency Transactions in Functional Currency

## Settlement of Monetary Items in FC

- **Change in Ex Rate – between Transaction Date and Date of Settlement** – results in exchange difference
- **Settlement in the same period** – All ex diff is recognized in that period
- **Settlement in subsequent period** – Ex diff recognized in each period up to the date of settlement

# Reporting Foreign Currency Transactions in Functional Currency

## Monetary Items that forms part of a reporting entity's NI in FO

Exchange difference is recognized

- in P&L in Separate FS of Reporting Entity or
- in P&L in Individual FS of the Foreign Operation

In Consolidated FS

- Such Ex Diff is shall be recognized initially in other comprehensive income and reclassified from equity to profit or loss
- On disposal of NI in FO



# Reporting Foreign Currency Transactions in Functional Currency

## Gain or Loss in Non Monetary Item

- Recognized in other Comprehensive Income – exchange component of that gain or loss is recognized in the other Comprehensive income ( IAS 16 requires gains or losses on revaluation of PPE to be recognized in other comprehensive income)
- Recognized in P& L – exchange component of that gain or loss is recognized in P&L

# Change in Functional Currency

Functional Currency of an entity reflects the underlying

- Transactions
- Events
- Conditions

Hence, Functional Currency once determine can be changed only if there is change to those underlying

- Transactions
- Events
- Conditions

# Change in Functional Currency

## Change in Entity's Functional Currency

- The entity shall apply translation procedure applicable to the new functional currency
- Prospectively
- From the Date of Change

**using the Exchange Rate at the Date of Change**

# Practical Example - 1

- An entity, with the dollar as its functional currency, purchases plant from a foreign entity for €18m on 31 May 2008 when the exchange rate was €2 to \$1. The entity also sells goods to a foreign customer for €10.5m on 30 September 2008, when the exchange rate was €1.75 to \$1. At the entity's year end of 31 December 2008, both amounts are still outstanding and have not been paid. The closing exchange rate was €1.5 to \$1.

# Practical Example - 1

The accounting for the items for the period ending 31 December 2008 would be as follows:

- The entity records the plant and liability at \$9m at 31 May 2008. At the year-end, the amount has not been paid. Thus using the closing rate of exchange, the amount payable would be retranslated at \$12m, which would give an exchange loss of \$3m in profit or loss. The asset remains at \$9m before depreciation.

# Practical Example - 1

- The entity will record a sale and trade receivable of \$6m. At the year-end, the trade receivable would be stated at \$7m, which would give an exchange gain of \$1m that would be reported in profit or loss. IAS 21 does not specify where exchange gains and losses should be shown in the statement of comprehensive income.

# Use of Presentation Currency other than Functional Currency

- An entity may present its financial statement in any currency ( or currencies)
- If the Presentation Currency differs from the functional currency of the entity, it translates its results and financial position to the presentation currency
- The results and financial position of an entity whose functional currency is not the currency of a hyper inflationary economy – shall be translated into a different presentation currency using the following procedure

# Use of Presentation Currency other than Functional Currency

- Assets and Liabilities of each statement of financial position presented shall be translated at the closing rate
  - At the date of that statement of financial position
  
- Income and expenses for each statement of comprehensive income or separate income statement presented shall be translated at exchange rates
  - At the dates of the Transaction
  
- All resulting exchange differences shall be recognized in other comprehensive income



# Translation of a Foreign Operation

- Follows normal Consolidation procedure
- Intragroup monetary assets or liability, whether short term or long term cannot be eliminated against corresponding intra group liability
- Treatment as assets and liabilities of the Foreign Operation
  - Any GW arising on the acquisition of a foreign operation
  - Any FV adjustments to the carrying amount of assets and liabilities on the acquisition of that foreign operation
  - They shall expressed in Functional Currency of the Foreign Operation
  - Shall be translated at the closing rate

# Disposal or Partial Disposal of a Foreign Operation

## On Disposal of a Foreign Operation

- Exchange Differences relating to that Foreign Operation
- Recognized in Other Comprehensive Income and Accumulated in a Separate Component of Equity
- Shall be reclassified from Equity to P&L
- When the gain or loss on disposal is recognized ( IAS 1 )
- On partial disposal proportionate share of the cumulative amount shall be reclassified to P&L

# **Disposal or Partial Disposal of a Foreign Operation**

## **The following accounted for as Disposals**

- Loss of Control of Subsidiary ( incl a Foreign Operation)
- Loss of Significant Influence over an Associate ( incl a Foreign Operation)
- Loss of Joint Control over a Jointly Controlled Entity ( incl a Foreign Operation)

# Practical Example - 2

- An entity has a 100%-owned foreign subsidiary, which has a carrying value at a cost of \$25m. It sells the subsidiary on 31 December 2008 for €45m. As at 31 December 2008, the credit balance on the exchange reserve, which relates to this subsidiary, was \$6m. The functional currency of the entity is the dollar and the exchange rate on 31 December 2008 is \$1 to €1.5. The net asset value of the subsidiary at the date of disposal was \$28m.

# Practical Example - 2

- The subsidiary is sold for \$45m divided by 1.5 million, therefore \$30m. In the parent entity's accounts a gain of \$5m will be shown. In the group financial statements, the cumulative exchange gain in reserves will be transferred to profit or loss, together with the gain on disposal. The gain on disposal is \$30m minus \$28m, therefore \$2m, which is the difference between the sale proceeds and the net asset value of the subsidiary. To this is added the exchange reserve balance of \$6m to give a total gain of \$8m, which will be included in the group statement of comprehensive income.

# SIC 7 Introduction of the Euro

This Interpretation addresses how the introduction of the Euro, resulting from the European Economic and Monetary Union (EMU), affects the application of IAS 21 *The Effects of Changes in Foreign Exchange Rates*

# SIC 7 Introduction of the Euro

- The requirements of IAS 21 should be strictly applied when a country joins the EU's Economic and Monetary Union and hence
- 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

# SIC 7 Introduction of the Euro

- 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.



# Tax Effects of all Exchange Differences

- Tax effects on
  - Gains and loss on FC Transactions and
  - Exchange Difference arising on translating the Results and Financial Position of an Entity into a different currency.
- IAS 12 Income Taxes applies to these tax effects ( Para 50 of IAS 21)

# Interaction between IAS 21 and IAS 12 Income Taxes

- Relevant Paragraphs in IAS 12: Paragraph 41 read with paragraph 39, 62(c) read with paragraph 61 and 78.
- Para 39 states: An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except...

# Interaction between IAS 21 and IAS 12 Income Taxes

- Para 41; If the entity's taxable profit or tax loss is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss

# Interaction between IAS 21 and IAS 12 Income Taxes

- Para 61&62(c): Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to exchange differences arising on the translation of the financial statements of a foreign operation is to be recognised in other comprehensive income

# Interaction between IAS 21 and IAS 12 Income Taxes

- PARA 78: Where exchange differences on deferred foreign tax liabilities or assets are recognised in the statement of comprehensive income, such differences may be classified as deferred tax expense (income) if that presentation is considered to be the most useful to financial statement users.

# Disclosure Requirements

An entity shall disclose

- Amount of Exchange Difference recognized in P&L a/c
- Net Exchange Differences recognized in other Comprehensive Income and Accumulated in a separate component of equity
- Reconciliation of the amount of such exchange difference at the beginning and end of the period

# Disclosure Requirements

- Statement of fact
  - when Presentation Currency is difference from that of the Functional Currency
  - of Change in the Functional Currency of the Reporting Entity
  - When entity presents its financial statements in a currency different from its functional currency
  - When an entity displays its financial statement or other financial information in a currency that is different from either its functional currency or presentation currency

# About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*
- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.*
- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*
- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*



# About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*
- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*
- *The author can be reached at [rajcumarradukia@caaa.in](mailto:rajcumarradukia@caaa.in)  
Mob – 09820061049 / 09323061049*
- *For more details log on to [www.caaa.in](http://www.caaa.in)*

# Thank You