



GLOBAL AUDIT LEARNING AND DEVELOPMENT

IAS 21 – The Effects of Changes in Foreign Exchange Rates

AUDIT

Learning objectives

- ◆ **Describe the definitions as per IAS 21**
- ◆ **Examine and Assess how foreign currency transactions and balances are translated into a company's functional currency**
- ◆ **Examine and Assess how foreign currency financial statements are translated for consolidation purposes**
- ◆ **Discuss disclosure requirements for the notes to financial statements**

Agenda

- ◆ **Definitions**
- ◆ **Foreign currency transactions**
- ◆ **Foreign currency financial statements**
- ◆ **Hyperinflationary economy**
- ◆ **Disclosure**

IAS 21 definitions

Functional currency

The currency of the primary economic environment in which the entity operates

Foreign currency

A currency other than the functional currency of an entity

Presentation currency

The currency in which the financial statements are presented

Determination of functional currency – Primary factors

Currency of the country whose economy determines sale prices of goods and services

Currency that influences sales prices (often denomination currency)

Currency that influences labour, material, other costs

But also...

Currency in which funds from financing activities are generated

Currency in which operating cash receipts are retained

Reflects the primary economic environment in which the entity operates

Determination of functional currency – Additional factors for foreign operations

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.

Degree of
operational
independence from
parent

Proportion of
transactions with
parent

Influence of cash
flows on parent's
cash flows

Financial
autonomy
compared with
parent

Choice of functional currency?

- ◆ **An entity does not have a free choice of functional currency**
- ◆ **An entity cannot change functional currency unless facts and circumstances relevant to its determination change**
- ◆ **Change should be applied prospectively**

IAS 21 functional currency – Summary

**Primary economic environment:
Currency and economy influencing sales
prices and operating costs**

Primary
indicator

**Currency in which
financing funds are
received and operating
receipts are retained**

**Extent of integration
with reporting entity
(foreign operations
only)**

Supporting
evidence

Mixed indicators? Use judgement to
choose FC that most faithfully presents
economic effects of underlying transactions

Example

- ◆ **Company A is a manufacturer of steel products. The majority of products are sold into the local market using the international price for steel, quoted in U.S. dollars. Competitive forces in the country also influence the local sales price.**
- ◆ **The majority of raw material purchases are from local suppliers, denominated in local currency, based on the price of steel, quoted in U.S. dollars, on the London Metal Exchange.**
- ◆ **These sales and raw material purchases are invoiced and settled in local currency. Most other expenses are in local currency as well.**
- ◆ **A significant amount of financing is in U.S. dollars to match the currency in which the sales are priced, while cash reserves are held in local currency.**

- ◆ **What is the functional currency of the company?**

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Reporting foreign currency transactions in the functional currency – Initial recognition

- ◆ **Recognise transaction at the rate at the transaction date**
- ◆ **May use e.g. average rate for week or month as a practical approximation**
 - Average rates not reliable if currency fluctuates significantly

Monetary assets

- ◆ **Cash**
- ◆ **Cash equivalents**
- ◆ **Debt securities**
- ◆ **Accounts receivable**
- ◆ **Notes receivable**

Items that will be received in a fixed or determinable amount of cash

Non-monetary assets

- ◆ Inventory
- ◆ Prepaid expenses
- ◆ Equity securities
- ◆ Investment property
- ◆ Property, plant, and equipment
- ◆ Intangible assets (e.g. goodwill)

Items that will not be received in a fixed or determinable amount of cash

Monetary liabilities

- ◆ **Accounts payable**
- ◆ **Notes payable**
- ◆ **Bonds payable**
- ◆ **Leases payable**
- ◆ **Accruals**
- ◆ **Deferred tax (usual classification)**

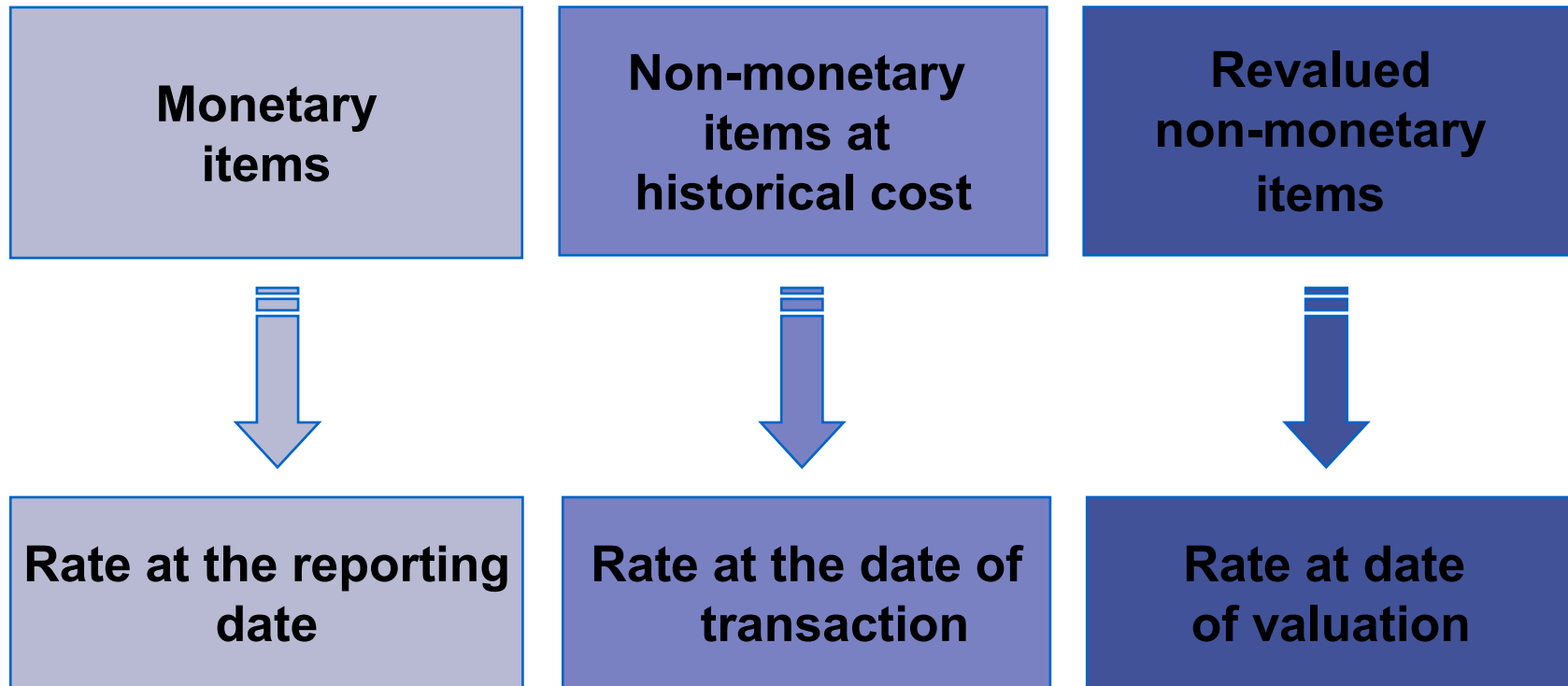
Items that will be paid out in a fixed or determinable amount of cash

Non-monetary liabilities

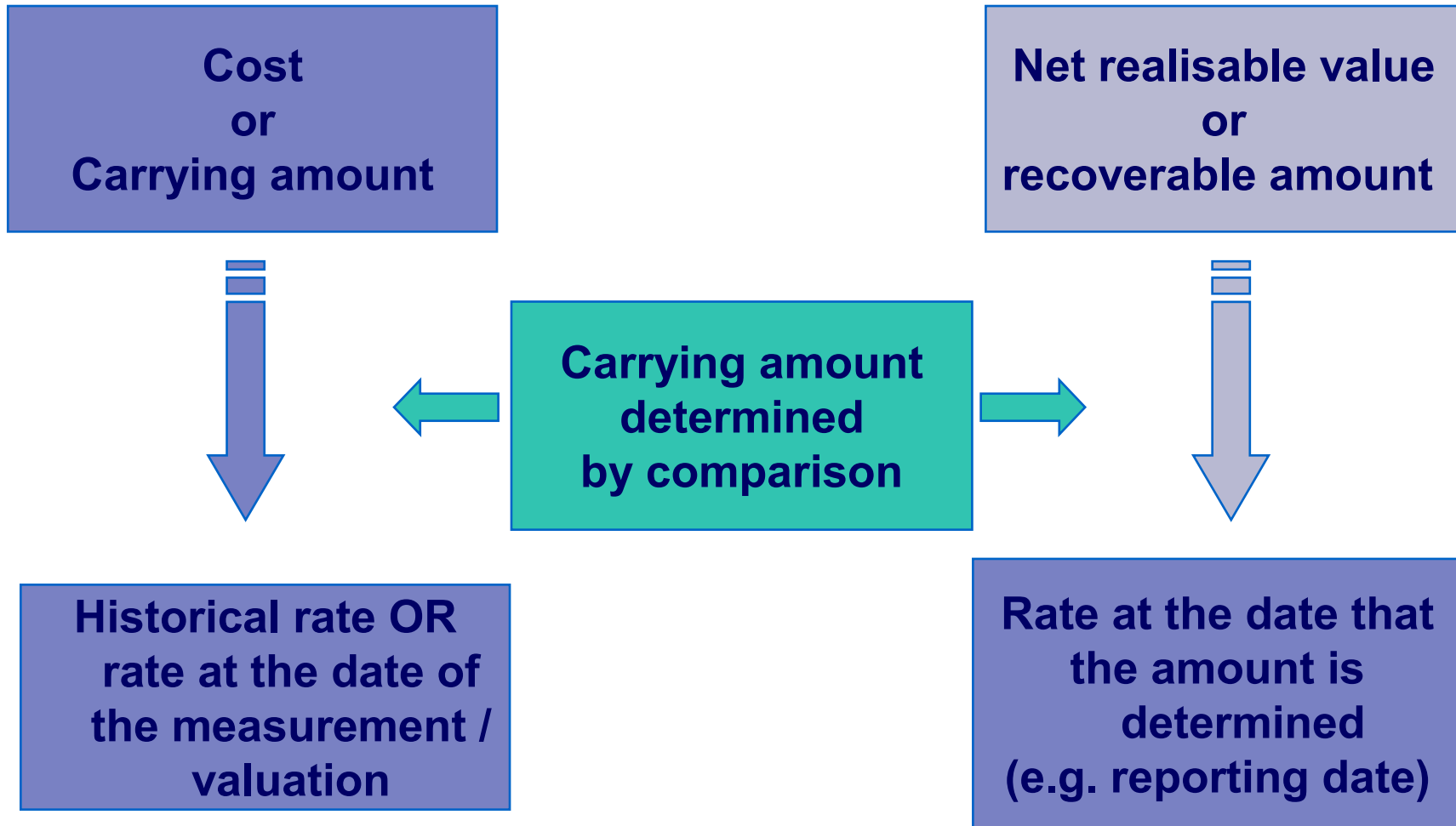
- ◆ **Deferred income**
- ◆ **Government grant**

**Items that will not be paid out
in a fixed or determinable
amount of cash**

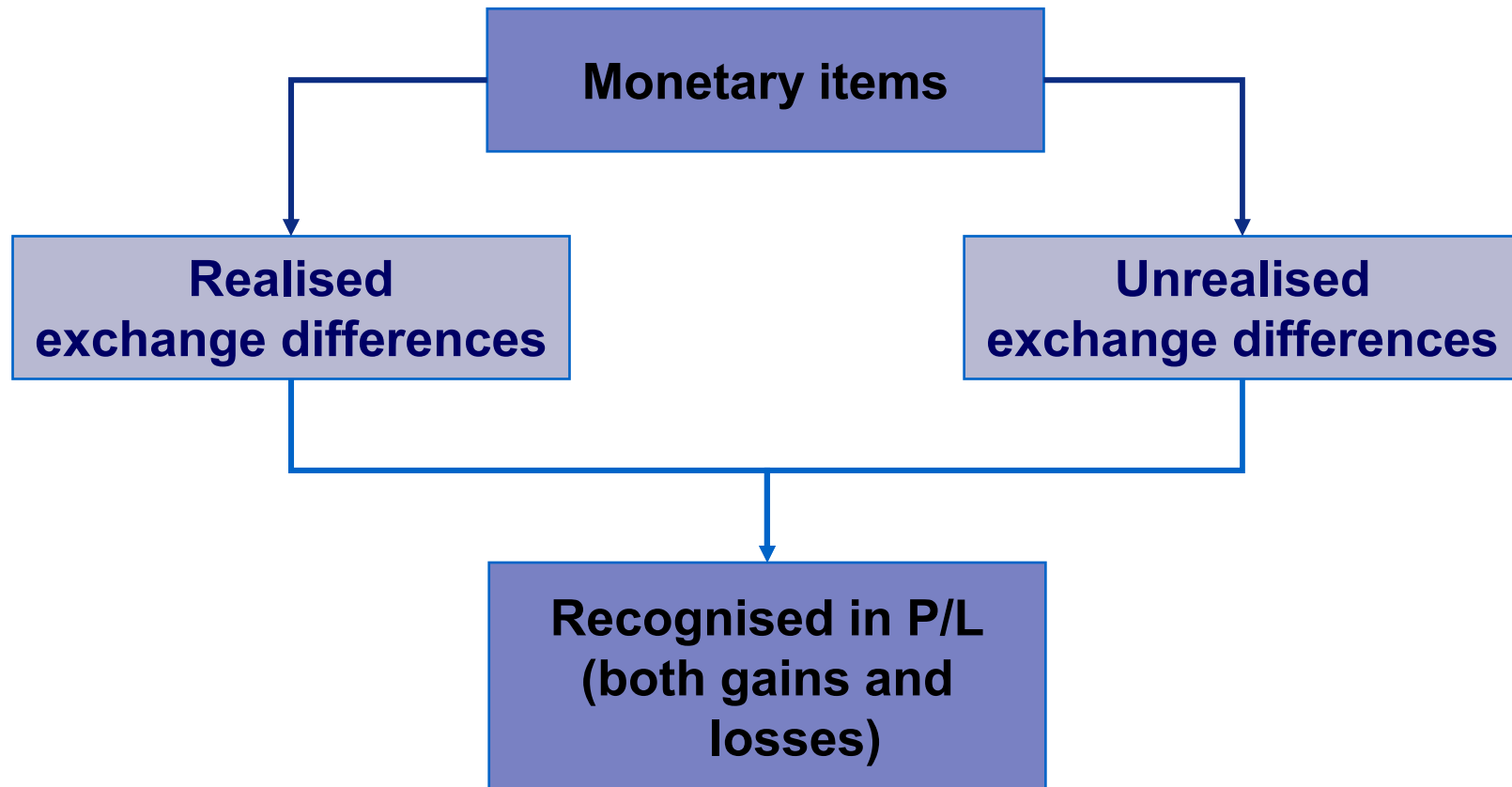
Reporting foreign currency transactions in the functional currency – Subsequent measurement



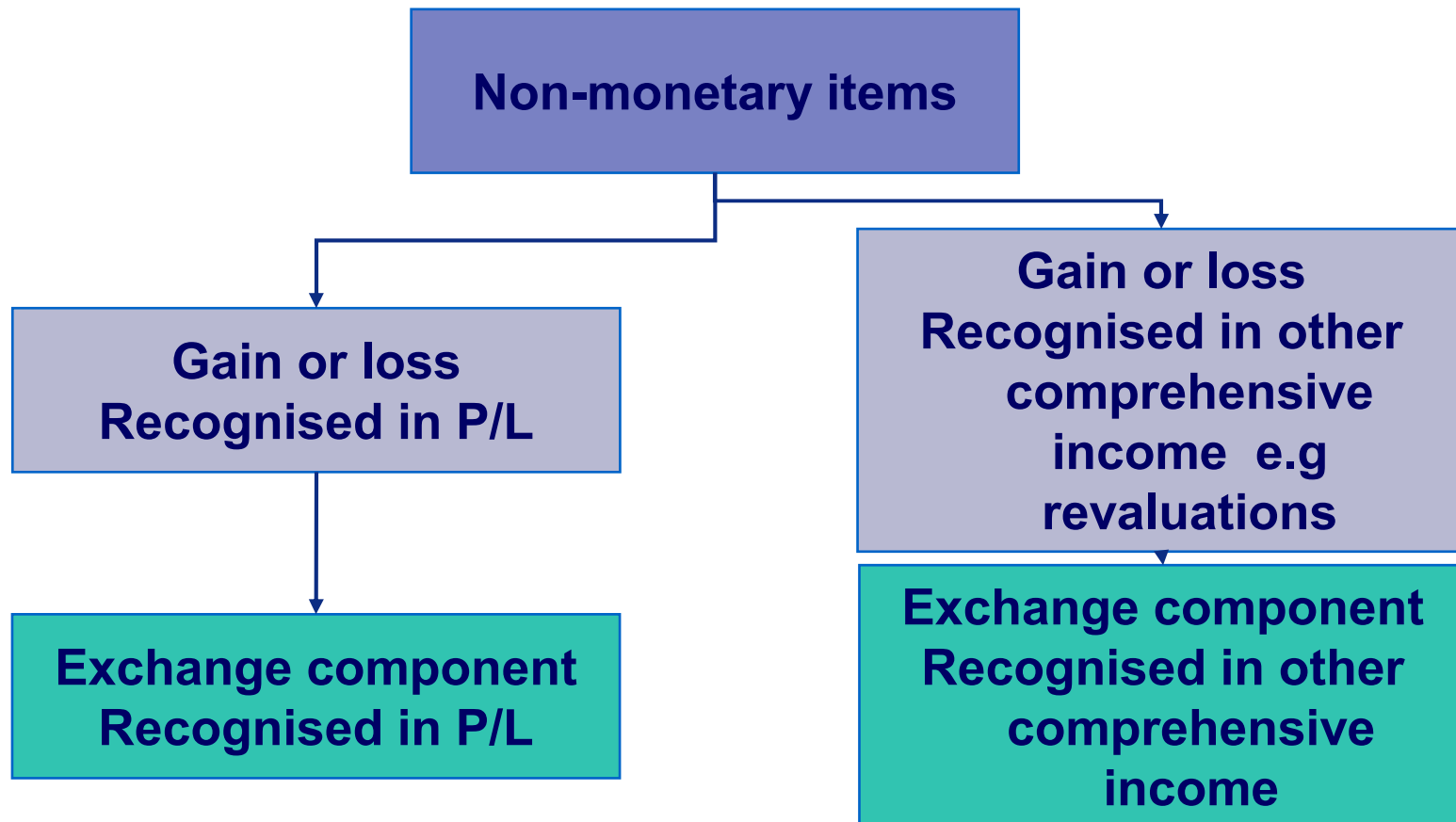
Reporting foreign currency transactions in the functional currency – “Impaired assets”



Monetary items – Exchange gains and losses



Non-monetary items – Exchange gains and losses



Change in functional currency

- ◆ **Only if there is a change to the underlying transactions, events and conditions**
- ◆ **Translation procedures should be applied to the new functional currency prospectively from the date of the change**

Example – Watch

What journal entries are required?

Purchase: Watch, Euro 100
Delivered: 20 December
Payment due: 31 January
Functional currency: USD

Euro/USD rate – 20 December 1/0.90
Euro/USD rate – 31 December 1/0.92

Example – Books

What journal entries are required?

Purchase: 20 books at Euro 10 per book
Delivered: 20 December
Payment due: 31 January
Functional currency: USD

Euro/USD rate – 20 December 1/0.90
Euro/USD rate – 31 December 1/0.80

Example – Books 2

Are any other journal entries required?

Purchase: 20 books at Euro 10 per book

Delivered: 20 December

Payment due: 31 January

Functional currency: USD

Euro/USD rate – 20 December 1/0.90

Euro/USD rate – 31 December 1/0.80

Expected selling price per book Euro 11

Example – Unrealized gains and losses

	Euro	Rate	USD
Sale of goods 20 Nov, Euro	100,000	.80	80,000
Collection of receivable 27 Dec, Euro	50,000	.90	45,000
Conversion of receivables to USD 31 Dec	50,000	.92	46,000

No other foreign currency transactions.

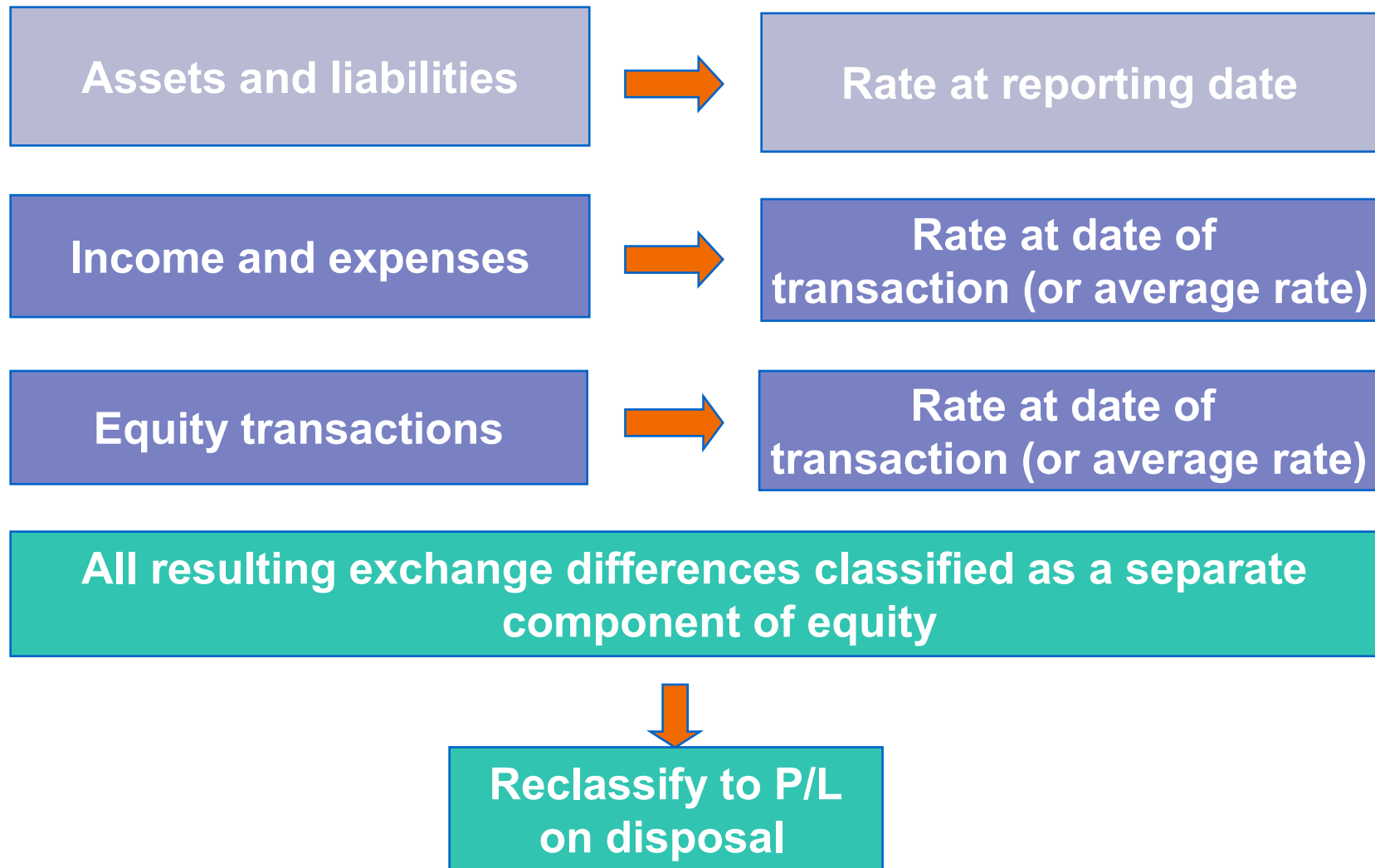
What will be the foreign exchange result recorded in the P/L under IAS 21?

**Total exchange gain in P/L: USD 11,000
(6,000 unrealised and 5,000 realised)**

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Translation to the presentation currency



Explanation of exchange rate difference

◆ Recalculation of the foreign exchange difference:

Opening equity components x CR – Opening equity components x HR

+

Net asset changes from P/L x (CR – HR)

+

Net asset changes from other equity transactions x (CR – HR)

=

Translation adjustment in other comprehensive income

CR = Rate at year end (closing rate)

HR = Historical or average rate

Translation of a foreign operation

- ◆ **Non-controlling interest allocated share of accumulated exchange difference**
- ◆ **Goodwill and fair value adjustments arising from a business combination are treated as assets/liabilities of the foreign operation translated at the reporting date**
- ◆ **Exchange gains and losses on intra-group items are taken to P/L**
- ◆ **Different year-ends**
 - 3 month lag permitted
 - Adjust for significant changes in exchange rates between different year-ends

Exchange differences – Net investment in a foreign operation

- ◆ **Net investment in a foreign operation – the amount of the entity’s interest in the net assets of that foreign operation**
- ◆ **If the settlement of monetary item receivable from or payable to a foreign operation is neither planned nor likely to occur in the foreseeable future, exchange differences on such item are recognised:**
 - In profit or loss by both the reporting entity and the foreign operation in their individual financial statements
 - In other comprehensive income and accumulated in a separate component of equity in the consolidated financial statements
 - Accumulated exchange differences are reclassified from equity to profit or loss on disposal of the foreign operation

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What is a hyperinflationary economy?

◆ No absolute rate at which hyperinflation is deemed to arise. Indicators:

- Population keeps its wealth in a stable currency or in non-monetary assets
- Population regards monetary amounts not in local currency but in terms of a stable currency e.g., prices quoted in a stable foreign currency
- Credit terms compensate for the expected loss of purchasing power during the credit period
- Interest rates, wages and prices are linked to a price index
- The cumulative inflation rate over three years is approaching or exceeds 100%

A matter of judgement!

- ◆ **IAS 29 does not give a definition of hyperinflation**
- ◆ **Becoming or ceasing to be hyperinflationary is a trend, not a discrete event**
- ◆ **Quantitative factors are not decisive in their own right, but need to be evaluated in the light of the economic circumstance and trends**
- ◆ **Judgement used in coordination with the local profession and local accounting standard setter, so that all companies in a country apply (or cease to apply) IAS 29 at the same time**

Foreign operations – Hyperinflationary economy

The entity's functional currency is the currency of a hyperinflationary economy

Local FS are restated by inflation index according to IAS 29
Resulting gain/loss on net monetary position is recorded in P/L

◆ **Assets and liabilities, equity items, income and expenses are translated into a different presentation currency:**

- Current year: Closing rate at the date of the most recent reporting period presented
- Comparatives: Closing rate at the most recent period *only if* presentation currency is a currency of hyperinflationary economy. If not, comparatives should not be restated – i.e. retain the comparatives as they were reported in the previous period.

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Key disclosures

◆ Exchange rate differences included in:

- P/L (except for financial instruments measured at FV through P/L)
- Other comprehensive income

◆ Reminders

- Refer to functional currency and presentation currency
- In accounting policy note disclose that P/L items are translated at rate at transaction dates

Additional disclosures

◆ Reasons (if applicable):

- Why there has been a change in the functional currency
- Why the presentation and functional currency are different

◆ If entity's presentation currency is different from its functional currency, its financial statements should be described as compliant with IFRSs only if all the requirements of IAS 21 are applied

Additional disclosures (continued)

- ◆ **If entity's additional financial information is displayed in a currency different from either its functional or its presentation currency and all the requirements of IAS 21 have not been met:**
 - Clearly identify such information as supplementary
 - Disclose the currency of the supplementary information
 - Disclose the entity's functional currency and the method of translation used as a basis for presenting the supplementary information

Recap quiz (1)

- ◆ **Which of these considerations would not be relevant in determining the entity's functional currency?**
 - A. The currency that influences sales prices for goods and services
 - B. The currency that mainly influences labor, material and other costs of providing goods or services
 - C. The most financially stable currency that is frequently used in business transactions
 - D. The currency in which funds from financing activities are generated

Recap quiz (2)

- ◆ **At the reporting date assets and liabilities denominated in a currency other than the entity's functional currency are translated as follows:**
 1. Monetary items are translated at the exchange rate at the end of the reporting period
 2. Non-monetary items carried at fair value are translated at the exchange rate at the end of the reporting period

- A. 1 is true, 2 is false
- B. 1 is false, 2 is true
- C. 1 is true, 2 is true
- D. 1 is false, 2 is false

Contact details

Joseph Kariuki

Senior Manager

jkariuki@kpmg.co.ke

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