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IAS® Standard 21 The Effect of Changes in Foreign Exchange Rates

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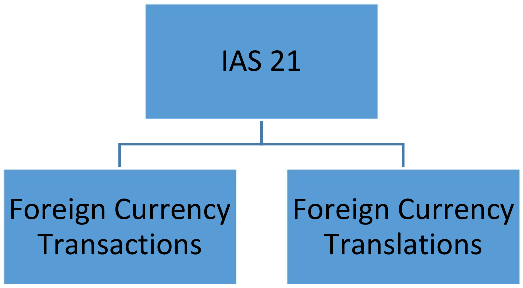
IAS® Standard 21 The Effects of Changes in Foreign Exchange Rates

SCOPE AND KEY DEFINITIONS

The impact of changes in foreign exchange rates are addressed in IAS Standard 21 The Effects of Changes in Foreign Exchange Rates. IAS 21 outlines how to account for foreign currency transactions and foreign operations in financial statements, as well as accounting for how to convert financial statements to a presentation currency. Figure 1 presents the scope of IAS 21.

Fig.1 Scope of IAS 21



IAS 21 addresses the following topics (IAS21.3):

- Accounting for transactions and balances in foreign currencies,
- Translating the results and financial position of foreign operations, included in the financial statements of the entity by consolidation, or the equity method,
- Translating the results and financial position of the entity into a presentation currency.

IAS 21 does not deal with(IAS21.4-7):

- Derivative transactions in foreign currencies and balances that are within the scope of IAS Standard 39 Financial Instruments: Recognition and Measurement or IFRS Standard 9 Financial Instruments.
- Hedge accounting including the hedging of a net investment in a foreign operation.
- The presentation of cash flows arising from transactions in a foreign currency, or with the translation of cash flows of a foreign operation.

To understand this standard correctly, we must know some basic definitions.

Functional Currency: The functional currency of an entity is the currency of the primary economic environment in which that entity operates (IAS21.8). The primary economic environment in which an entity operates is normally the one in which it primarily generates and spends cash.

Foreign Operations: A foreign operation is an entity that:

- Is a subsidiary, associate, joint arrangement, or branch of a reporting entity, and
- Has activities that are based or conducted in a country or currency other than those of the reporting entity (IAS21.8).

Presentation Currency: The currency in which the reporting entity's financial statements are prepared. The presentation currency can be any currency of choice.

Foreign Currency Transaction: A foreign currency transaction is one that is denominated or requires settlement in a foreign currency.

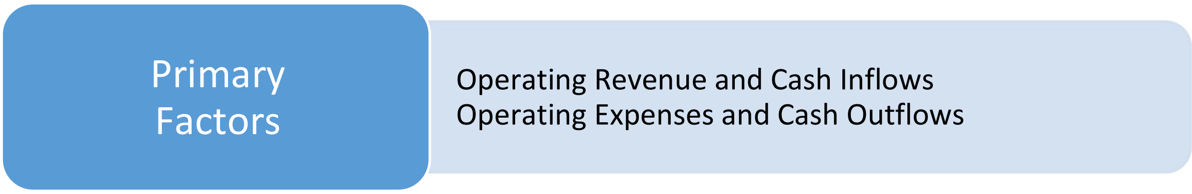
Monetary Items: Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. The essential feature of a monetary item is the right to receive a fixed or determinable number of units of currency.

FUNCTIONAL CURRENCY

The functional currency is determined by applying the factors in IAS 21. It cannot be chosen freely by an entity. Once determined, it cannot be changed unless there is a change in the underlying circumstances. IAS 21 details the factors, primary and secondary, that an entity must consider in determining its functional currency.

The primary factors give the clearest indication of the functional currency of an entity. Fig.2 details the primary factors that an entity would consider.

Fig.2 Primary Factors



The secondary factors give secondary evidence of the functional currency of an entity. Fig.3 details the secondary factors that an entity would consider.

Fig.3 Secondary Factors

Correctly determining the functional currency can have a major impact on the financial statements. For example, if it is determined incorrectly, transactions in the correct functional currency will be recorded as if they were foreign currency transactions. Hence, exchange differences will be recognized on transactions for which no foreign exchange difference should have arisen.

For example, on 1 October 2021, Entity A buys an inventory for CUX 115,000. The exchange rate is CUY 1 = CUX 1.15. The inventory has a cost of CUY 100,000.

At 31 October 2021, the payable is settled and the exchange rate is CUY 1 = CUX 1.16. The payment is settled at CUX 115,000, which is now equivalent to CUY 99,138.

If the entity has a functional currency of CUY, a gain of CUY 862 will be taken to the statement of profit or loss and other comprehensive income. If the entity's functional currency is the CUX, the payment has not changed in value (CUX 115,000) so there is no gain or loss.

FUNCTIONAL CURRENCY OF A FOREIGN OPERATION

The functional currency is determined separately for individual entities. There is no such thing as a group functional currency. In particular, the additional factors in IAS 21 are used to determine whether the functional currency of the foreign operation is the same as that of the reporting entity.

- If the activities of the foreign operation are carried out as an extension of those of the reporting entity, rather than with a significant degree of autonomy, then this provides evidence that its functional currency should be the same as that of the reporting entity.
- If transactions with the reporting entity are a high proportion of the activities of the foreign operation, this provides evidence that its functional currency may be the same as that of the reporting entity, as the entity may be considered an extension of the parent's operations.
- If cash flows from activities:
    - Directly affect the cash flows of the reporting entity; and
    - Are readily available for remittance to the reporting entity,

  then this provides evidence that its functional currency is the same as that of the reporting entity.

- If cash flows from its activities are not sufficient to service debt obligations without funds from the reporting entity then this provides evidence that its functional currency is the same as that of the reporting entity.

PRESENTATION CURRENCY

If the presentation currency differs from the functional currency, the results and financial position have to be translated into the presentation currency.

Presenting the financial statements in a currency other than the functional currency does not change the way in which the underlying items are measured. It merely expresses the underlying amounts in a different country which are measured in the functional currency.

When a group contains entities with different functional currencies, the results and financial position of each entity must be expressed in a common currency in order to produce group financial statements. The presentation currency of the group financial statements is often the parent's functional currency.

Entity's presentation currency may differ from its functional currency such as:

- A corporate group may have extensive operations in many countries and conduct its business largely in international markets. It may be difficult to identify an appropriate presentation currency. An international currency such as USD or Euro may be used. This is often used by entities that raise capital in international markets to benefit the users of the financial statements.
- In some jurisdictions, entities are required to present their financial statements in the local currency event if this is not the functional currency.
- An entity may wish to present its financial statements in the functional currency of the parent if it is different from its own functional currency.

FOREIGN CURRENCY TRANSACTIONS

A foreign currency transaction is one that is denominated or requires settlement in a foreign currency.

For example, an entity may:

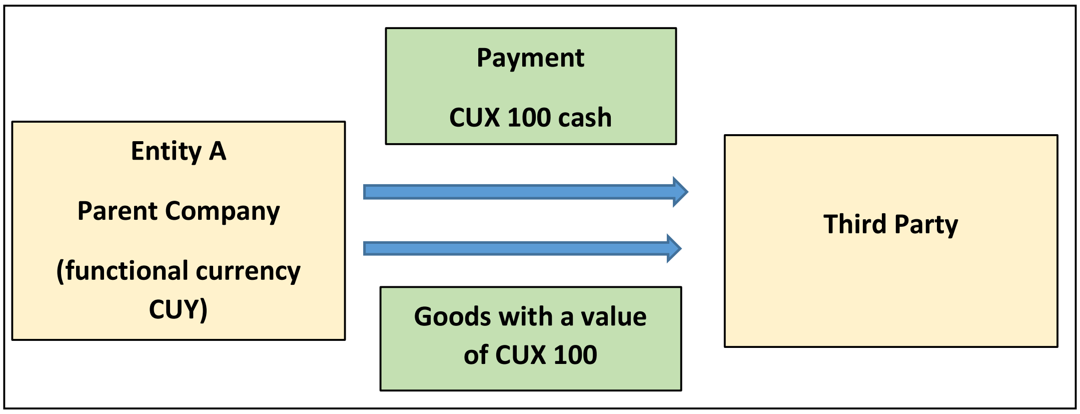
- Buy or sell goods or services in a foreign currency;
- Borrow or lend funds when the amounts payable or receivable are in a foreign currency; and
- Acquire or dispose of assets, or incur or settle liabilities, in a foreign currency.

Since an entity enters into such transactions directly, it is exposed to the cash flow effects of changes in the foreign currency. An entity must convert foreign currency items into its functional currency for recording in its books of account.

Once recorded, exchange differences where currency changes affect the recorded balances will arise.

A foreign currency transaction is entered into directly by an entity. They often occur on a day-to-day basis. They involve cash flows, and increase or decrease the net assets of the entity. Figure 4 presents an example of a foreign currency transaction that an entity may enter.

Fig.4 Foreign Currency Transaction



These transactions are recorded in the functional currency by applying to the foreign currency the amount of the spot exchange rate between:

- The functional currency; and
- The foreign currency at the date of the transaction.

Example: An entity (functional currency CUX) buys inventory for CUY 15,000 on credit on February 23, 2022. The spot rate is CUX 1 = CUY 1.5. The transaction is recorded at CUX 10,000 (15,000/1.5).

Feb 23, 2022	Dr.	Inventory	10,000	
	Cr.	Trade payable		10,000

Occasionally an entity may not keep its books and records in its functional currency. For example, for ease of management reporting, a subsidiary may keep its books and records in the functional currency of its parent entity and not its own.

If an entity keeps its books in a different currency, all amounts are measured into the functional currency using the historical rate on initial recognition. Subsequent to this, only monetary items denominated in a foreign currency should be remeasured. This produces the same amounts as would have occurred had the items been recorded initially in the functional currency.

The treatment of foreign currency items at the end of the reporting period depends on whether the item is: monetary or non-monetary; and carried at historical cost or fair value.

* At the end of each reporting period, foreign currency ***monetary items*** are translated using ***the closing rate.***

Example: An entity (functional currency CUY) has an outstanding trade payable for CUX 1,500 which arose from a transaction when the spot exchange rate was CUY 1 = CUX 1.2 and hence was initially recorded at CUY 1,250. The closing rate is CUY 1 = CUX 1.5 on December 31, 2021.

The payable is therefore CUY 1,000 (1,500/1.5) at the end of the reporting period.

Dec 31, 2021	Dr.	Trade Payable	250*	
	Cr.	Gain On Foreign Currency Transaction		250

* CUY 250 = CUY 1,250 – CUY 1,000

* At the end of each reporting period, ***non-monetary items*** that are measured in terms of ***historical cost*** in a foreign currency are translated using ***the exchange rate at the date of the transaction***.

Example: An entity (functional currency CUY) purchased a machine for CUX 12,000 when the spot exchange rate was CUY 1 = CUX 1.2. The closing rate is CUY 1 = CUX 1.5.

The machine is shown as CUY 10,000 (12,000/1.2) at the end of the reporting period. No journal entry will be made as a result of the change in the exchange rates regarding the machine purchased in foreign currency.

* At the end of each reporting period, ***non-monetary items*** that are measured at ***fair value*** in a foreign currency are translated using ***the exchange rates at the date when the fair value is determined***.

Example: An entity (functional currency CUY) owns a building. The entity carries buildings at their fair value. The valuation of the building was done at the end of the reporting period and fair value was CUX 150,000. The building was purchased for CUX 100,000 (CUY 83,333) when the spot exchange rate was CUY 1 = CUX 1.2. The closing rate is CUY 1 = CUX 1.5 on December 31, 2021.

The building is shown as CUY 100,000 (150,000/1.5) on December 31, 2021.

Dec 31, 2021	Dr.	Buildings	16,667*	
	Cr.	Other Comprehensive Income		16,667

* CUY 16,667 = CUY 100,000 – CUY 83,333

Carrying amount of an item is determined in conjunction with other relevant IFRS. Sometimes the carrying amount of an item is determined by comparing two or more amounts.

Example:

- The lower of cost or net realisable value (IAS 2 Inventories)

- The lower of an asset’s previous carrying amount and it’s recoverable amount (IAS 36 Property, Plan and Equipment)

When the asset is non-monetary and is measured in a foreign currency, the carrying amount is determined as the lowest of the following values:

- The cost or carrying amount translated at the Exchange rate at the date that amount was determined (the rate at the transaction date for items carried at historical cost)
- The net realisable value or recoverable amount translated at the Exchange rate at the date that value was determined (closing rate if the value was determined at the end of the reporting period)

FOREIGN CURRENCY TRANSLATIONS

Many consolidated groups are comprised of many individual entities with different functional currencies. The individual entities will record transactions in their books in the functional currency. For consolidation purposes, each entity’s financial statements must be translated into the presentation currency of the consolidated group if it differs from their functional currency.

The translation process is also used for a stand-alone reporting entity producing financial statements in a presentation currency, which differs from both its functional currency and the presentation currency of any group of financial statements it is contained in.

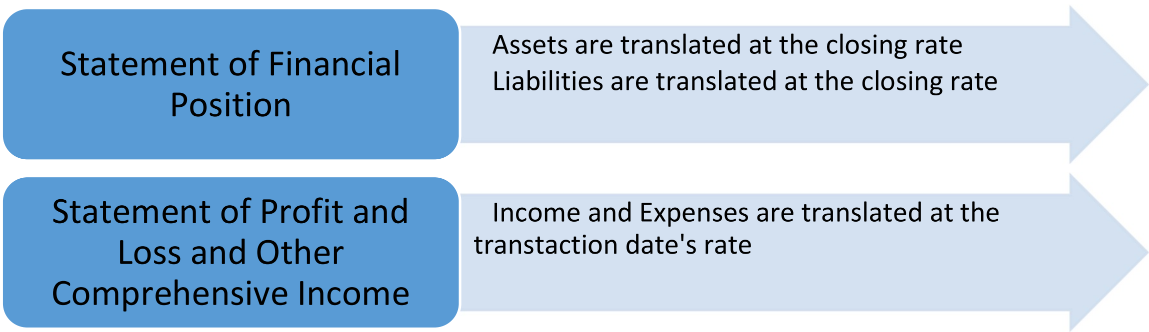
A translation of an entity’s financial statements is carried out to present them in a specific presentation currency. It is often done to present the financial statements of a foreign operation in the functional currency of a parent. This is done so the foreign operation can be included in the financial statements of the reporting entity by consolidation or the equity method.

Consequently, translations are usually carried out at the end of the reporting period or at interim periods for reporting purposes.

IAS 21 allows an entity’s financial statements to be presented in any currency. If an entity’s presentation currency differs from its functional currency, the entity’s results and financial position must be translated into it. As shown in Figure 5;

- For each statement of financial position presented, assets and liabilities are translated at the closing rate at the date of that statement of financial position.
- For each statement presenting profit or loss and other comprehensive income, income and expenses are translated at the exchange rates at the transaction dates (an average rate for a period may be used unless rates fluctuate significantly).

Fig 5. Exchange Rates for Translation of Financial Statements



All resulting exchange differences are recognized ***in other comprehensive income***. These exchange differences are not recognized as income or expenses for the period because the changes in exchange rates have little or no direct effect on the present and future cash flows from the entity's operations.

The exchange differences arising from translation of an entity into a presentation currency result from translating:

- Income and expenses recognized in the period at the exchange rates, at the transaction dates, and assets and liabilities at the closing rate; and
- The opening net assets at a closing rate that differs from the previous closing rate.

DISPOSAL OF FOREIGN OPERATION

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. An example of an abandonment would be an entity with two separate operations (a clothes retail chain and a pharmacy chain) abandoning one of the operations and focusing on the other one.

On the disposal of a foreign operation, the cumulative translation amount of exchange differences that:

- Have been recognized in other comprehensive income and accumulated in a separate component of equity; and
- Which relate to that foreign operation,

are reclassified from equity to profit or loss when the gain or loss on disposal is recognized.

An example of a type of exchange difference would be the exchange difference arising on translation of foreign operation into a presentation currency for incorporation into the consolidated financial statements of a group.

On disposal of the foreign operation by the reporting entity, these exchange differences are reclassified from equity to profit or loss when the gain or loss on disposal is recognized. For example, if a parent entity disposes of 90 percent of its holding of the share capital with voting rights of a wholly owned subsidiary, then all the accumulated translation reserve will be reclassified into profit or loss.

DISCLOSURES

An entity shall disclose:

- The amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with IFRS 9; and
- Net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period (IAS 21.52).

When the presentation currency differs from the functional currency, that information must be acknowledged, together with the functional currency's disclosure and the justification for choosing a different presentation currency.

When the reporting entity's or a significant foreign operation's functional currency changes, this and the reason for the change in functional currency must be declared.

When a business provides financial statements in a currency other than its functional currency, the financial statements must be described as complying with IFRSs only if they meet all of the IFRSs' requirements, including the translation process outlined in IAS 21.

EXAMPLE

Entity B has a 100% owned subsidiary named Entity A. Entity B’s functional currency and reporting currency is CUX. Entity A maintains its books and records in CUY, its functional currency. The financial statements of Entity A are to be translated (from the functional currency CUY to the presentation currency CUX) for incorporation into Entity B’s financial statements.

Entity A’s statement of financial position at December 31, 2021 and its statement of profit and loss and other comprehensive income for the year ending on December 31, 2021 are presented below in CUY.

Entity A Statement of Financial Position as of December 31, 2021 (in CUY)			
Cash	10,000	Accounts Payable	50,000
Accounts Receivable	40,000	Unearned Revenue	20,000
Inventories	70,000		
Equipment	100,000	Retained Earnings	30,000
Accumulated Depreciation	(20,000)	Equity	100,000
Total Assets	**200,000**	**Total Liabilities and Owners Equity**	**200,000**

Entity A Statement of Profit and Loss and Other Comprehensive Income For the Year 2021 (in CUY)	
Revenues	260,000
Expenses	220,000
Net Income	**40,000**

Various assumed exchange rates for 2021 are as follows:

January 1, 2021	CUY 1 = CUX 0.90
Weighted-average for 2021	CUY 1 = CUX 1.05
April 15, 2021*	CUY 1 = CUX 1.1
December 31, 2021	CUY 1 = CUX 1.25

* The dividends (10,000 CUY) were declared and the unearned revenue was received.

Entity A’s financial statements must be translated into CUX in terms of the provisions of IAS 21. This translation process is illustrated below.

All assets and liabilities are translated using the closing rate at the end of the reporting period (CUY 1 = CUX 1.25). Owner’s equity accounts are translated by using historical exchange rates (CUY 1 = CUX

0.90). The translated balance of retained earnings is the result of the weighted average rate applied to revenues and expenses and the specific rate in effect when the dividends were declared (CUY 1 = CUX 1.15).

Entity A **Statement of Financial Position Translation** **December 31, 2021**			
Assets	**CUY**	**Exchange Rates**	**CUX**
Cash	10,000	1.25	12,500
Accounts Receivable	40,000	1.25	50,000
Inventories	70,000	1.25	87,500
Equipment (net)	80,000	1.25	100,000
Total Assets	**200,000**		**250,000**
Liabilities and Owner's Equity			
Accounts Payable	50,000	1.25	62,500
Unearned Revenue	20,000	1.25	25,000
Retained Earnings	30,00		30,500
Equity	100,000	0.90	90,000
Gain on Foreign Currency Translation			42,000
Total Liabilities and Owner's Equity	**200,000**		**250,000**

All revenues and expenses should be translated at the rates in effect when these items are recognized during the period. Due to practical considerations, however, weighted average rates can be used to translate revenues and expenses (CUY 1 = CUX 1,05) only if such weighted average rates approximate actual rates that were ruling at the time of the transactions.

Entity A **Statement of Profit and Loss and Other Comprehensive Income Translation** **For the Year 2021**			
	CUY	**Exchange Rates**	**CUX**
Revenues	260,000	1,05	273,000
Expenses	220,000	1,05	(231,000)
Net Income	**40,000**		**42,000**

	CUY	**Exchange Rates**	**CUX**
Net Income	40,000		42,000
(-) Dividend	(10,000)	1,15	(11,500)
Retained Earnings	**30,000**		**30,500**

Cumulative exchange differences (translation adjustments) result from translating all assets and liabilities at the closing rate, while owner's equity is translated by using historical rate and weighted average rate (revenues and expenses). The adjustments have no direct effect on cash flows; however, changes in exchange rate will have a direct effect on sale or liquidation. The effect is due to the net investment rather than the subsidiary's operations. For these reasons, the translation adjustments balance is reported as "other comprehensive income item" in the statement of financial position.