Accounting (Basics) - Lecture 9

Foreign currency translation

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Functional currency

- Each entity shall identify its functional currency. An entity's functional currency is the currency of the primary economic environment in which the entity operates.
- The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. Therefore, the following are the most important factors an entity considers 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), and
     ii. of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
  b) the currency that mainly influences labor, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Functional currency

c) the currency in which funds from financing activities (issuing debt and equity instruments) are generated.

d) the currency in which receipts from operating activities are usually retained.

- The following additional factors are considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity:

  a) whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it.

Functional currency

b) whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

c) whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

d) whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

Reporting foreign currency transactions in the functional currency

- A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:
  a) buys or sells goods or services whose price is denominated in a foreign currency;
  b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
  c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.
- An entity shall record a foreign currency transaction, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with these IFRS. For practical

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reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

- At the end of each reporting period, an entity shall:
  a) translate foreign currency monetary items using the closing rate;
  b) translate non-monetary items that are measured in terms of historical cost in a foreign currency using the exchange rate at the date of the transaction; and
  c) translate non-monetary items that are measured at fair value in a foreign currency using the exchange rates at the date when the fair value was determined.

Reporting foreign currency transactions in the functional currency

- An entity shall recognize, in profit or loss in the period in which they arise, exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous periods, except as described in guidance for net investment in a foreign operation.

Net investment in a foreign operation

- An entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.
- Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation shall be recognized in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate. In the financial statements that include the foreign operation and the reporting entity, such exchange differences shall be recognized initially in other comprehensive income and reported as a component of equity. They shall not again be recognized in profit or loss on disposal of the net investment.

Change in functional currency

- When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change. The functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once the functional currency is determined, it can be changed only if there is a change to those underlying transactions, events and conditions. For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency.
- The effect of a change in functional currency is accounted for prospectively. In other words, an entity translates all items into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost.

Use of a presentation currency other than functional currency

- An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, the entity shall translate its items of income and expense and financial position into the presentation currency.
- An entity whose functional currency is not the currency of a hyperinflationary economy shall translate its results and financial position into a different presentation currency using the following procedures:
    a) Assets and liabilities for each statement of financial position presented (i.e. including comparatives) shall be translated at the closing rate at the date of that statement of financial position.

Use of a presentation currency other than functional currency

b) Income and expenses for each statement of comprehensive income (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions.

c) All resulting exchange differences shall be recognized in other comprehensive income.

- For practical reasons, an entity may use a rate that approximates the exchange rates at the dates of the transactions, for example an average rate for the period, to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.
- The exchange differences result from:

a) translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate, and

b) translating the opening net assets at a closing rate that differs from the previous closing rate.

Use of a presentation currency other than functional currency

- In incorporating the assets, liabilities, income and expenses of a foreign operation with those of the reporting entity, the entity shall follow normal consolidation procedures, such as the elimination of intragroup balances and intragroup transactions of a subsidiary. However, an intragroup monetary asset (or liability), whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated

Use of a presentation currency other than functional currency

financial statements, a reporting entity continues to recognize such an exchange difference in profit or loss or the entity shall classify it as equity.

- Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be treated as assets and liabilities of the foreign operation. Thus, they shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate.

Disclosures

- An entity shall disclose the following:
  a) the amount of exchange differences recognized in profit or loss during the period,
  b) the amount of exchange differences arising during the period and classified in a separate component of equity at the end of the period.
- An entity shall disclose the currency in which the financial statements are presented. When the presentation currency is different from the functional currency, an entity shall state that fact and shall disclose the functional currency and the reason for using a different presentation currency.
- When there is a change in the functional currency of either the reporting entity or a significant foreign operation, the entity shall disclose that fact and the reason for the change in functional currency.