IND AS 21

The Effects of Changes in Foreign Exchange Rates

Agenda

- Objectives, Scope and Key Definitions
- Functional and Presentation Currency
- Net investment in Foreign Operations
- Translation Approach
- Presentation and Disclosure
- Comparison with Indian GAAP and Ind AS 21

Objectives, Scope and Key Definitions

Objective

- An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In addition, an entity may present its financial statements in a foreign currency.
- The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.
- The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

Scope

This Standard shall be applied:

(a) in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of Ind AS 109, Financial Instruments;

(b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation or the equity method; and

(c) in translating an entity's results and financial position into a presentation currency.

Scope (Cont'd)

This Standard does not apply to:

(a) hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. Ind AS 109 applies to hedge accounting.

(b) the presentation in a statement of cash flows of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation.

(c) long-term foreign currency monetary items for which an entity has opted for the exemption given in paragraph D13AA of Appendix D to Ind AS 101. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items

Key Definitions

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a subsidiary, associate, joint arrangement 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.

Functional currency is the currency of the primary economic environment in which the entity operates.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

Presentation currency is the currency in which the financial statements are presented.

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Functional and Presentation Currency

Functional Currency

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.

Functional Currency (contd.)

Factors to be considered in determining functional currency:

1. **Ind AS 21.9 factors (Primary)**

   a) the currency:
   - 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
   - of the country whose competitive forces and **regulations** mainly determine the sales prices of its goods and services

   b) the currency that mainly influences **labour, material and other cost of providing goods and services**

2. **Ind AS 21.10 factors (Secondary) to be considered**

   - currency in which funds from **financing activities** are generated
   - currency in which receipts from **operating activities** are retained

Functional Currency (contd.)

Example - Facts

- Entity A operates an oil refinery in Saudi Arabia.
- All of the entity's income is denominated and settled in US dollars.
- The oil price is subject to the worldwide supply and demand, and crude oil is routinely traded in US dollars around the world.
- Around 45% of entity A's cash costs are imports or expatriate salaries denominated in US dollars.
- Remaining 55% of cash expenses are incurred in Saudi Arabia and denominated and settled in riyal.

Functional Currency (contd.)

Example - Conclusion

- **The functional currency of entity A is US dollars. The crude oil sales prices are influenced by global demand and supply.**
- Crude oil is globally traded in US dollars around the world. The revenue analysis points to US dollars.
- Cost analysis is mixed. Depreciation (or any other noncash expenses) is not considered.
- Operating cash expenses are influenced by the riyal(55%) and the US dollar (45 %). Management is able to determine the functional currency as US dollars, as revenue is clearly influenced by US dollars and expenses are mixed.

Functional Currency (contd.)

Example - Facts

- Entity A is a US bank with a US dollar functional currency.
- Entity A establishes a structured entity in a European country in order to invest in a European bond portfolio
- Entity A has funded the structured entity with equity and intercompany debt denominated in euros.
- The structured entity uses the financing to purchase a portfolio of euro government bonds. There is no intention for the structured entity to perform any activities other than holding the bond portfolio.
- The directors are all employees of the US parent, and the structured entity has no active management of its own.

Functional Currency (contd.)

Example - Conclusion

- **The functional currency of the structured entity is US dollars, as the entity has no operations and does not provide any services.**
- The primary indicators, therefore, do not apply. The ‘financing’ indicator supports the euro, as all financing is in euros.
- However, all the financing is intercompany and entity A could denominate the financing in any currency it wanted.
- Considering the ‘autonomy’ indicator, it is clear the structured entity is not autonomous. It is a shell entity, has no independent activities and no active management of its own.

Functional Currency (contd.)

- 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

Functional Currency (contd.)

Factors to be considered in determining functional currency:

3. **Ind AS 21.11** contains **additional factors** to be considered when determining the functional currency of a **foreign operation**:

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.

An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

Functional Currency (contd.)

Factors to be considered in determining 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.

Functional Currency (contd.)

Additional factors to be considered to determine whether the functional currency of a **foreign operation** is the same as that of reporting entity

Factors to consider	Factor suggests that functional currency is the same as that of the parent?
The activities of the foreign operation are carried out as an extension of the reporting entity	Yes
The activities of the foreign operation are autonomous	No
Transactions with the reporting entity are a high proportion of the foreign operation's activities	Yes
Cash flows of the foreign operation directly affect the cash flows of the parent or are available for remittance to the reporting entity	Yes
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 parent	No

Case Study 1

Facts:

Holding Company H Ltd has a business of supplying raw Iron Ore to major Steel Makers abroad. For this purpose it engages its subsidiary S Ltd in India.

S Ltd which takes orders from Indian customers and receives goods from the holding. It also collects proceeds which is always in Indian INR & remits it to the parent company.

Whole of the funding of the subsidiary is being managed by the parent company including administration and other expenses. There is no other role being played by S Ltd.

Issue :

Determine whether the functional currency of H Ltd. (i.e. USD) can be considered as that of the subsidiary S Ltd?

Case Study 1 (contd.)

Solution:

- Since the operations of S Ltd is simply an extension of operations of H Ltd. S Ltd does not have significant degree of autonomy.
- Hence currency Indian INR can not be considered as functional currency of S Ltd.
- For this purpose the currency of the parent company i.e. USD will be considered as functional currency of the subsidiary also.

Case Study 2

Facts:

The functional currency of company M (M) is INR. M establishes 2 companies, P and Q. Company P is incorporated in the US and Q in the UK.

M loaned £2 million to each company, Q also borrowed an additional £ 3 million from an unrelated third party. P guaranteed this loan.

Q used £ 5 million to build a manufacturing facility to serve the UK market .

Q intends to repay the loan to the third party through the profit generated though its manufacturing operations.

P used the loan to invest in marketable securities in international markets.

Issue:

What are the functional currencies of P and of Q?

Case Study 2 (contd.)

Solution:

Q’s Functional Currency

Pound sterling (£) would be Q's functional currency.

It is the currency of the country that influences the sale prices and costs of its goods, as well as the regulations and competitive forces.

P’s Functional Currency

P is domiciled in the US, but its activities are carried out as an extension of M, such that those activities could have been carried out directly in the M's books.

P should use the INR as its functional currency.

Case Study 3

Facts:

Sparkle is an Indian diamond mining company and a joint venture.

- 50% owned by Shine (USA-based company, functional currency U.S. dollar)
- 50% owned by Brighten (UK-based company, functional currency GBP)

Sparkle has a strong Indian team in management and ex-Brighten Managing Director.

American laws govern diamond trade worldwide and all sales are made in U.S. dollars.

In 2015, Shine sold its share in Sparkle to Brighten.

Issue:

Determine the functional currency of Sparkle in 2014 and 2015.

Case Study 3 (Cont'd)

Solution (Year 2014):

- Although a mix of indicators exists, the U.S. dollar is deemed the functional currency of Sparkle in the year 2014, as this is the currency that:
  - Influences both the sales prices of goods and services, and
  - Whose competitive forces and regulations determine the sales prices
- Above factors are primary indicators that U.S. dollar is the functional currency of Sparkle.
- Indicators given in paragraph 9 of Ind AS 21 takes precedence over paragraphs 10 and 11 indicators.

Case Study 3 (Cont'd)

Solution (Year 2015):

- In the year 2015, there appears to be insufficient change in underlying transactions, events, and conditions to initiate a change in functional currency and it, therefore, remains as U.S. dollar.
- If Sparkle were less autonomous, the situation may well have been a change in functional currency due to its dependency on Brighten and the currency that influences the sales may have changed

Functional Currency (contd.)

Functional currency

- Each entity should determine its own functional currency

- Selection of the functional currency is **not a free choice**, but is based on underlying facts and circumstances

- Functional currency reflects
  - the underlying transactions,
  - Events, and
  - conditions that are relevant to it.

- Functional currency is changed **only** when there is a change in the above.

- A change in functional currency is accounted for **prospectively**

Case Study 4

Facts:

ABC, located in India, is a wholly owned subsidiary of Company K (K).

- The U.S. dollar is K's functional currency and ABC has identified INR as its functional currency.
- The functional currency was identified because ABC's sales and purchases were denominated primarily in INR, as were all of ABC's labour costs.

During the fourth quarter, ABC's operations began to change:

- ABC's sales decreased due to a loss of some sizable contracts while K's sales increased due to new significant contracts.
- ABC terminated its sales force because ABC will no longer need to generate its own sales since more than 80 percent would be coming from K's operations.
- K built a new facility to produce the materials needed in its manufacturing processes. As of the end of the fiscal year, ABC began receiving all materials from K instead of from outside vendors.
- Based on the changes in ABC's business, ABC expects cash inflows and outflows, except for wages, primarily to be denominated in U.S. dollars.

Issue:

Do these circumstances justify a change in ABC's functional currency from INR to the U.S. dollar?

Case Study 4 (Cont’d)

Solution:

Yes. Paragraph 36 of Ind AS 21 states that a change in the currency that mainly influences the sales prices of goods and services may lead to a change in functional currency.

The U.S. dollar appears to become the currency that would be influencing the sales price going forward.

Additionally, the changes in activities of ABC result in the foreign operation essentially being an extension of the reporting entity consistent with paragraph 11(a) of Ind AS 21.

Functional vs presentation currency

- **Presentation currency:**
  - choice of any currency
  - no change in underlying measurement of items, merely expressing these in different currency

Net investment in Foreign Operations

Net Investment in Foreign operations

- 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 recognised 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 (e.g. consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment.

Foreseeable Future

- Ind AS 21 is silent regarding identifying a specific time period

- Therefore, the term "foreseeable future" is not meant to imply a specific time period.

- Instead, this is an intent-based indicator.

- A parent may qualify for the exception under Ind AS 21.15 if:

  1) There has been no history of repayments, and
  2) The parent company can represent that
     - it does not intend to require repayment of an inter-company account (which cannot be represented if the debt has a maturity date that is not waived), and
     - the parent company's management views the inter-company account as part of its investment in the foreign subsidiary.

Case Study 5

Background

Entity A (A), whose functional currency is pound sterling, has a foreign operation in the form of a wholly owned subsidiary, Entity B (B), with a euro functional currency.

Entity B issues to A perpetual debt (i.e. it has no maturity) denominated in euros with an annual interest rate of 6 per cent.

The perpetual debt has no issuer call option or holder put option.

Thus, contractually it is just an infinite stream of interest payments in euros.

Question

In A's consolidated financial statements, can the perpetual debt be considered, in accordance with Ind AS 21.15, a monetary item "for which settlement is neither planned nor likely to occur in the foreseeable future" (i.e. part of A's net investment in B), with the exchange gains and losses on the perpetual debt therefore being recorded in equity?

Case Study 5 (Cont’d)

Answer

Yes.

Through the origination of the perpetual debt, A has made a permanent investment in B.

The interest payments are treated as interest receivable by A and interest payable by B, not as repayment of the principal debt.

Hence, the fact that the interest payments are perpetual does not mean that settlement is planned or likely to occur.

The perpetual debt can, given the lack of specific guidance to the contrary, be considered part of A's net investment in B.

In accordance with Ind AS 21.15, the foreign exchange gains and losses should be recorded in equity at the consolidated level because settlement of that perpetual debt is neither planned nor likely to occur.

Translation Approach

Translation Approach

- **Functional currency**
  - Determine the Functional Currency
  - Translate foreign currency items in to functional currency
  - Report the differences on translation according to the standard
- **Presentation currency**
  - The standard permits presentation of accounts in any currency
  - If Presentation Currency is different from functional currency then translate the results and financial position in accordance with this standard
- **In a group (with subsidiaries/ associates/ JVs)**
  - Reporting entity (Parent company) presents the group account in any currency (called as Presentation Currency)
  - Translate other individual entity’s accounts into presentation currency of parent (if different)

Translation Approach (contd.)

Initially at spot exchange rate between foreign currency and functional currency at date of transaction

Subsequently at each balance sheet date :

- **Monetary items —** retranslated at closing rate
- **Non-monetary items measured at historical cost —** remain at historical spot rate
- **Non-monetary items measured at fair value — translated** using spot exchange rate at date when fair value was determined

Translation Approach (contd.)

Recognition of exchange differences

- **Monetary items —** Income statement (subject to Ind AS 109 and limited exception in Ind AS 21 relating to items forming part of the net investment in a foreign operation)
  - Ind AS 21 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in profit or loss.
  - An exception is a monetary item that is designated as a hedging instrument in a cash flow hedge, a hedge of a net investment or a fair value hedge of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income

- Foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when intragroup monetary item is transacted between two group entities that have different functional currencies.

Translation Approach (contd.)

A UK parent entity has a wholly owned subsidiary in the US. During the year ended 31 December 20X5, the US entity purchased plant and raw materials to be used in its manufacturing process from the UK parent. Details of the transactions are as follows:

	Exchange rate
Purchased plant costing £500,000 on 30 April 20X5	£1 = US$1.48
Paid for plant on 30 September 20X5	£1 = US$1.54
Purchased raw materials costing £300,000 on 31 October 20X5	£1 = US$1.56
Balance of £300,000 outstanding at 31 December 20X5	£1 = US$1.52
Average rate for the year	£1 = US$1.55

The following exchange gains/losses will be recorded in the US subsidiary's income statement for the year ended 31 December 20X5.

	US$	US$
Plant costing £500,000 @ 1.48	740,000	
Paid £500,000 @ 1.54	770,000	
Exchange loss – settled transaction		(30,000)
Raw materials costing £300,000 @ 1.56	468,000	
Outstanding £300,000 @ 1.52	456,000	
Exchange gain – unsettled transaction		12,000
Net exchange loss recorded in income statement		(18,000)

Translation Approach (contd.)

The exchange loss of US$30,000 that arises as the inter-company payable for plant purchase is settled during the year will flow through on consolidation when the US subsidiary's results are incorporated in the consolidated financial statements. The inter-company payable of US$456,000 in the US subsidiary's balance sheet that remains outstanding will be translated into sterling at the closing rate to £300,000 and will be eliminated against the receivable recorded in the UK parent's inter-company account. However, the exchange gain of US$12,000 will not be eliminated on consolidation and will be reported as part of the consolidated results of the group. The rationale of keeping this gain in the group's result is that to repay the payable balance, the US subsidiary will some day have to expend the amount of US dollars necessary to acquire the required amount of the reporting currency. This exposes the group to a gain or loss on reconversion.

Translation Approach (contd.)

Recognition of exchange differences (Contd.)

- Ind AS 21 permits an option to recognise exchange differences arising on translation of certain long-term monetary items from foreign currency to functional currency directly in equity.
- In this situation, Ind AS 21 requires the accumulated exchange differences to be transferred to profit or loss in an appropriate manner.
- **Non-monetary items —** Foreign exchange gain or loss is recognised in same place **(equity/income statement)** as the gain or loss on non-monetary item
- This Standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. Ind AS 109 applies to hedge accounting.

Translation Approach (contd.)

Example

On 1 November 20X1, Company A (sterling functional currency) buys a building for US$50,000,000, with full payment being made on that date. The exchange rate is US$1.68:£1. At the end of Company A's reporting period, 31 December 20X1, the building is not depreciated because it is not yet available for use. The exchange rate is US$1.71:£1 and the fair value of the building is US$60,000,000 at that date.

The journal entries are as follows:

1 November 20X1	£	£
Dr Property, plant and equipment	29,761,905	
Cr Cash		29,761,905

Being recognition of the US$ transaction in the functional currency at the exchange rate at the time of the transaction US$1.68:£1.

Translation Approach (contd.)

Example

Depending on whether Company A accounts for its buildings at cost less accumulated depreciation and impairment losses, or at a revalued amount, subsequent accounting entries are as follows:

At cost less accumulated depreciation and impairment losses

31 December 20X1

The building is a non-monetary item and held at historical cost. It continues to be measured at £29,761,905 (i.e. at the transaction rate).

At revalued amount

31 December 20X1

The building is a non-monetary item and held at fair value. It is retranslated at the rate of exchange at the date of valuation.

		£	£
Dr	Property, plant and equipment	5,325,814	
Cr	Revaluation gain (other comprehensive income)		5,325,814

Being recognition of a gain in fair value of £5,325,814 (£35,087,719 – £29,761,905), which includes the exchange component.

Translation Approach (contd.)

Translation to the presentation currency

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

- assets and liabilities at each balance sheet date at closing rate
- income and expenses at rates at transaction dates (practical approximations)
- all resulting exchange differences recognised in other comprehensive income

Translation Approach (contd.)

Disposal of Foreign Operation:

- Cumulative amount of exchange differences recognised in equity will be included in profit or loss on disposal of foreign operation
- Need to track cumulative translation adjustments in respect of foreign operations for recycling to income statement on disposal
- Disposal means sale, liquidation, repayment of share capital, or abandonment

Presentation and Disclosure

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 Ind AS 109; 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.

- When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of 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, that fact and the reason for the change in functional currency shall be disclosed.

Comparison with Indian GAAP and Ind AS 21

GAAP Comparison

Topic	Indian GAAP	IAS 21	Ind AS 21
Functional & Presentation Currency	Foreign currency is a currency other than the reporting currency which is the currency in which financial statements are presented. There is no concept of functional currency.	Functional currency is the currency of the primary economic environment in which the entity operates. Foreign currency is a currency other than the functional currency. Presentation currency is the currency in which the financial statements are presented.	Similar to IAS 21

GAAP Comparison

Topic	Indian GAAP	IAS 21	Ind AS 21
Exchange Differences	Similar to IAS 21, except that exchange differences on translation of certain monetary foreign currency items can be capitalised in the carrying amount of assets or otherwise deferred in a Foreign Currency Monetary Item Translation Difference Account (FCMITDA) which is then recognised in Profit or Loss over the balance period of the related foreign currency item. Exchange differences on monetary items, that in substance, form part of net investment in a foreign operation, are recognised in 'Foreign Currency Translation Reserve' both in the separate and consolidated financial statements.	Exchange differences arising on translation or settlement of foreign currency monetary items are recognised in profit or loss in the period in which they arise. Exchange differences on monetary items, that in substance, form part of net investment in a foreign operation, are recognised in profit or loss in the period in which they arise in the separate financial statements and in other comprehensive income in the consolidated financial statements.	Same as IAS 21 except that Ind AS 21 permits an option to recognise exchange differences arising on translation of certain long-term monetary items from foreign currency to functional currency directly in equity. In this situation, Ind AS 21 requires the accumulated exchange differences to be transferred to profit or loss in an appropriate manner.

GAAP Comparison

Topic	Indian GAAP	IAS 21	Ind AS 21
Scoping for derivatives	AS 11 is applicable to exchange differences on all forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities but is not applicable to the exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risks of future transactions in respect of which firm commitments are made or which are highly probable forecast transactions.	Foreign currency derivatives that are not within the scope of IFRS 9 (e.g. some foreign currency derivatives that are embedded in other contracts) are within the scope of IAS 21. In addition, IAS 21 applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency.	Similar to IAS 21

GAAP Comparison

Topic	Indian GAAP	IAS 21	Ind AS 21
Translation in consolidated financial Statements	Translation of a foreign operation to the reporting currency of the parent / investor depends on the classification of that operation as integral or non-integral.	Assets and liabilities should be translated from functional currency to presentation currency at the closing rate at the date of the statement of financial position; income and expenses at actual/average rates for the period; exchange differences are recognised in other comprehensive income and recycled to profit or loss on disposal of the operation.	Similar to IAS 21
	Treatment for disposal does not depend on whether control over a foreign subsidiary is lost or not. Even if control is lost, only proportionate amount of the reserve is recycled to statement of profit and loss.	Treatment of disposal depends on whether control is lost or not. Thus, if control is lost, the exchange difference attributable to the parent is reclassified to profit or loss from foreign currency translation reserve in other comprehensive income.	Similar to IAS 21

GAAP Comparison

Topic	Indian GAAP	IAS 21	Ind AS 21
Change in functional currency	Change in reporting currency is not dealt with in AS 11, though reason for change is required to be disclosed.	Change in functional currency is applied prospectively. The fact of change in functional currency and the reason for the change in functional currency should be disclosed.	Similar to IAS 21. Additionally, the date of change in functional currency is also required to be disclosed.

Thanks