

# 8. Effects of changes in foreign exchange rates



## Summary

This chapter covers:

- Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*



A 'foreign currency transaction' is a transaction that is denominated or requires settlement in a currency other than an entity's functional currency (i.e. in a foreign currency). Before applying this definition and the guidance on foreign currency transactions, an entity first considers whether there is a foreign currency or other embedded derivative that requires separation.



## Key principles

### General principles

Ind AS 21 should be applied 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*
- Translating the results and balance sheet of foreign operations that are included in the financial statements of the entity by consolidation or the equity method and
- Translating an entity's results and balance sheet into a presentation currency.

### Functional currency

- The entity measures its assets, liabilities, income and expenses in its functional currency, which is the currency of the primary economic environment in which it operates. An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.
- Transactions that are not denominated in an entity's functional currency are foreign currency transactions.



## Recognition

### Initial recognition

- A foreign currency transaction should be recorded 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.

### Subsequent measurement

- At the end of each reporting period:
  - Foreign currency monetary items should be translated using the closing rate
  - Non-monetary items that are measured in terms of historical cost in a foreign currency should be translated using the exchange rate at the date of the transaction and
  - Non-monetary items that are measured at fair value in a foreign currency should be translated using the exchange rates at the date when the fair value was measured.

### Presentation currency

- The entity may present its financial statements in a currency other than its functional currency (presentation currency). The entity that translates its financial statements into a presentation currency other than its functional currency uses the same method as for translating the financial statements of a foreign operation.

### Disposal or partial disposal of a foreign operation

- If an entity disposes of its entire interest in a foreign operation or loses control over a foreign subsidiary, or retains neither joint control nor significant influence over an associate or joint arrangement as a result of partial disposal, then the cumulative amount of the exchange differences relating to that foreign operation, recognised in Other Comprehensive Income (OCI) and accumulated in the separate component of equity, should be reclassified from equity to the statement of profit and loss (as a reclassification adjustment) when the gain or loss on disposal is recognised.
- A partial disposal of a foreign subsidiary without the loss of control leads to proportionate reclassification of the cumulative exchange differences from OCI to Non-Controlling Interest (NCI).

### Supplementary financial information

- An entity may present supplementary financial information in a currency other than its presentation currency if certain disclosures are made.



### Significant differences from IFRS<sup>1</sup>

- Ind AS 101, read with Ind AS 21, provides companies with an option to continue the policy adopted as per previous GAAP/AS in accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period.
- When there is a change in functional currency of either the reporting entity or a significant foreign operation, IAS 21, *The Effects of Changes in Foreign Exchange Rates*, requires disclosure of that fact and the reason for the change in functional currency. Ind AS 21 requires an additional disclosure of the date of change in functional currency.



1. Indian Accounting Standards (Ind AS): An Overview (Revised 2019) issued by ICAI.

## Practical implications arising out of ITFG clarifications

### Determination of functional currency

Often situations arise where a company may have two or more distinct business with different functional currencies. The accounting principles in Ind AS 21 provide that functional currency is the currency of the primary economic environment in which the entity operates.

Functional currency needs to be identified at the entity level, considering the economic environment in which the entity operates, and not at the level of a business or a division.

Ind AS 21 provides additional guidance with respect to factors which an entity should consider while determining its functional currency. These factors include the following:

- Currency that influences sales prices for goods and services and is of a country whose competitive forces and regulations determine the sales prices of its goods and services
- Currency that influences labour, material and other costs of providing goods or services
- Currency in which funds from financing activities are generated and
- Currency in which receipts from operating activities are usually retained. (ITFG 3, Issue 3)

### Determination of presentation currency for CFS

Entities within a group may have different functional currencies. Ind AS 21 requires each entity to determine its functional currency and translate foreign currency items into functional currency and report effects of such translation in the financial statements. Ind AS 21 also permits an entity to use a presentation currency for reporting its financial statements that differs from its functional currency.

Ind AS 21 provides specific guidance on translating the results and balance sheet of an entity into a different presentation currency.

If an entity is statutorily required to present its financial statements in a currency which is different from its functional currency, then it may do so by choosing the other currency as its presentation currency and applying the translation procedures as given in Ind AS 21.

Additionally, the auditor of such an entity (whose financial statements are prepared in a presentation currency which is different from its functional currency) would be required to give an auditor's report on financial statements prepared in the presentation currency. (ITFG 7, Issue 2)

### Disclosure of foreign exchange differences separately from other fair value changes

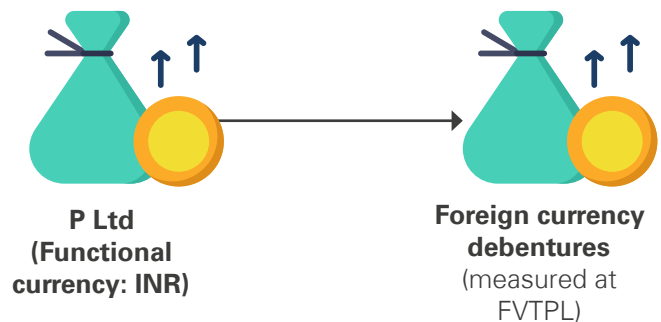
Generally, Ind AS 109 requires a gain or loss on a financial asset that is measured at fair value to be recognised in profit or loss<sup>2</sup>. In the case of a financial asset denominated in a foreign currency and measured at Fair Value Through Profit or Loss (FVTPL), the fair value is determined in the following two steps:

- Firstly, the fair value is determined in the relevant foreign currency
- Next, it is translated into the functional currency in accordance with the requirements of Ind AS 21.

Thus, as explained above, the change in fair value of such a financial asset during a period arises due to following two factors:

- Change in fair value expressed in terms of foreign currency
- Change in exchange rate.

In a scenario discussed at ITFG, an entity, P Ltd. holds an investment in debentures<sup>3</sup> denominated in a foreign currency. These debentures are measured at FVTPL in accordance with Ind AS 109, and the functional currency of P Ltd. is INR.



- The exceptions to this general principle are as follows:
  - It is a part of hedging relationship
  - It is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in OCI
  - It is a financial liability designated as at FVTPL and the entity is required to present the effects of changes in the liability's credit risk in OCI
  - It is a financial asset measured at Fair Value through Other Comprehensive Income (FVOCI) and the entity is required to recognise some changes in fair value in OCI.
- This investment is not designated as a hedging instrument in a cash flow hedge of an exposure to changes in foreign currency rates. Accordingly, ITFG was of the view that it would not be covered within the exceptions to the general principle enunciated in Ind AS 109 but would be measured at FVTPL.



ITFG considered the issue whether the foreign exchange difference is required to be presented separately from other fair value changes in the statement of profit and loss.

Ind AS 21 specifically excludes financial instruments measured at FVTPL from its requirement of disclosure of the amount of the amount of exchange differences recognised in profit or loss.

Further, Ind AS 109 does not contain any requirement for separation of change in fair value of a foreign-currency denominated financial asset measured at FVTPL into the two constituent parts (i.e. change in fair value expressed in terms of foreign currency and change in exchange rate).

Accordingly, in the given case, ITFG clarified that P Ltd is not required to present change in fair value of the investment in debentures on account of change in relevant foreign exchange rate separately from other changes in the fair value of the investment. (*ITFG 20, Issue 1*)

