CHAPTER 2

Determination of functional currency by a first-time adopter of Ind AS

This article aims to:

- Highlight the key principles to be considered when determining the functional currency of a first-time adopter of Ind AS

Background

Businesses in India have witnessed significant expansion and globalisation, and are operating in more than one jurisdiction, and dealing in global and domestic currencies. It is thus essential that companies record transactions in the financial statements in the main currency in which businesses are being conducted.

The Indian Accounting Standards (Ind AS), vide Ind AS 21, *The Effects of Changes in Foreign Exchange Rates,* introduced the concept of a functional currency, which is the currency of the primary economic environment in which an entity operates. Entities are required to record all transactions undertaken by them - i.e. all income and expenses, and measure their assets, liabilities and equity in the functional currency. Thereafter, entities should present the financial statements in a currency, which may or may not be the functional currency (referred to as the presentation currency)[1].

The determination of the functional currency is imperative, as currencies other than the functional currency would be considered as 'foreign currencies' and recorded and disclosed as such. However, the determination of the functional currency requires the assessment of certain factors and indicators, as prescribed in Ind AS 21, as can be read in the article ahead.

1. The presentation currency is generally chosen by the reporting entity depending on the statutory requirements of the legislation where they are located.

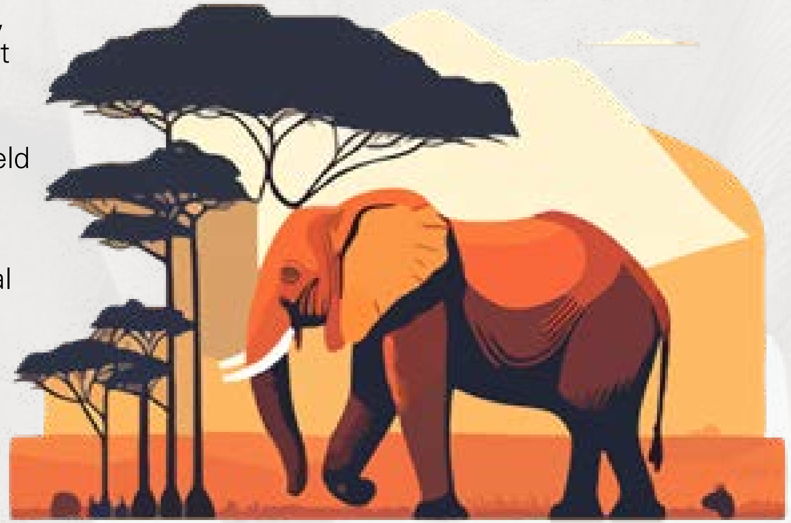
Facts of the case

X Pvt. Ltd. (the company) is a company incorporated in India, and provides stand-alone towage and marine solutions to various customers in and outside India. Till March 2023 the company was maintaining its books of accounts as per the accounting standards (Indian Generally Accepted Accounting Principles i.e. IGAAP) however, it is required to prepare its financial statements as per Ind AS for FY2024-25, with the date of transition as 1 April 2023. As part of the transition, the company needs to evaluate its functional currency.

X Pvt. Ltd. sends its tugs on hire to oil rigging companies for time or voyage charters. Contracts for these charters are fixed in USD (since freight rates for tugs are determined through a bid, where global players are involved). 70 per cent of the company's customers are Indian companies, hence invoices are raised in INR (USD equivalent amounts). Indian regulations that deal with the subsidy for Indian flagged tugs also impact the prices determined. The amounts received are held as fixed deposits with banks.

The company purchases its tugs from its parent entity based in Singapore, which has a functional currency of USD. The valuation of the tugs is in USD, and contracts are entered in USD. The company also avails borrowings in USD to fund these purchases. Borrowings constitute approximately 80 per cent of the company's capital employed. The expenses incurred by the company include - crew cost (whose contracts are based on global rates – as they can also join foreign companies, but amount is paid in INR), fuel cost-paid in USD, financing cost paid in USD.

What would be the functional currency of the entity? Is there any specific accounting treatment that the company should adopt for its balances as at the transition date?



Evaluating the case by referring to Ind AS 21

For most entities, the functional currency is the currency of the country in which the entity is located (the local currency). However, it cannot be assumed that the local currency will in all cases be the functional currency. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. For example, if pricing of most of the transactions of an entity are mostly influenced by the economic forces of another country that has a different currency, then its functional currency might be that other currency. Identification of functional currency depends on the facts and circumstances of an entity and requires exercise of judgement based on the analysis of its facts while keeping in mind the guidance given in Ind AS 21.

Ind AS 21 has provides primary and secondary factors for determining an entity's functional currency. Priority is given to the primary indicators, before considering the secondary indicators.

		Requirements of Ind AS 21	Evaluation in the context of X Pvt. Ltd.
Primary factors	1	**Currency that influences the sales prices** The currency that mainly influences sales prices for goods and services - this will often be the currency in which sales prices are denominated.	Charter contracts are agreed and entered into with all customers (domestic and international customers) in USD. Although, invoices are raised in INR, but this amount represents INR equivalent of the USD amount on the date of billing.
	2	**Competitive forces and regulations** The currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.	The freight rates for all charter agreements are negotiated in USD globally. As per the facts of the case, the market prices for freight are generally global prices set in USD and are determined based on global demands and supplies.
	3	**Currency that influences expenses** The currency that mainly influences labour, material and other costs of providing goods and services - this will often be the currency in which these costs are denominated and settled.	The expenses incurred by the company largely include - crew salary, fuel, finance cost and vessel amortisation cost. All these expenses constitute more than 85 per cent of the total expense and are majorly denominated and paid in USD.
Secondary factors	4	**Funds from financing activities** The currency in which funds from financing activities are generated; this would be the currency in which the entity's debt and equity instruments are issued.	Of the total funds available with the company, 80 per cent is borrowed in the form of an external commercial borrowing in USD. Remaining 20 per cent is the equity of the company, including the reserves earned from the regular operating activities.
	5	**Receipts are retained** The currency in which receipts from operating activities are usually retained.	The major portion of the company collections are received in INR, and the company retains the amount in fixed deposits in INR.

(Source: KPMG in India's analysis, 2023 read with Ind AS 21)

Based on the assessment of the primary factors, it is likely that the Company's functional currency is USD as it most faithfully represents the economic effects of its activities and transactions. However, management should apply judgement and consider all relevant information before concluding its functional currency.

Presentation currency of the company

As per Ind AS 21, presentation currency is the currency in which the financial statements are presented. Although an entity measures items in its financial statements in its functional currency, it may decide to present its financial statements in a currency or currencies other than its functional currency.

Since, the company is registered in India under the Companies Act, 2013, it would need to present its financial statements in INR. Hence, the presentation currency of the company would be INR.

Since the functional currency of the company is different from its presentation currency, the company would need to translate the financial statements using the procedures that are the same as those for translating foreign operations.

Procedures for translating functional currency to presentation currency

If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency.

For an entity whose functional currency is not the currency of a hyperinflationary economy:

- Assets and liabilities for each balance sheet presented (including comparatives) should be translated at the closing rate at the date of the balance sheet
- Income and expenses for each statement of profit and loss presented (including comparatives) should be translated at exchange rates at the dates of the transactions (or for practical reasons an average rate may be used if it approximates the actual rate)
- All resulting exchange differences should be recognised in other comprehensive income

First Ind AS financial statements

In the previous GAAP, the company was preparing and presenting the financial statements in INR. For the purpose of preparing the financial statements under Ind AS, the company would be required to prepare its financial statements in its functional currency[2]. Therefore, on the date of transition it would need to translate its IGAAP financial statements (in INR) into Ind AS (in USD).

Ind AS 101, *First-time Adoption of Indian Accounting Standards* **does not** allow a first-time adopter to simply translate its opening Ind AS financial statements into the functional currency using the spot rate at the date of transition.

Therefore, a first-time adopter is required to consider the appropriate functional currency since inception because otherwise the carrying amount of non-monetary assets may be misstated in the opening Ind AS financial statement.

Considering this, a first-time adopter could consider using the deemed cost exemption for property, plant and equipment, intangible assets and investment property. If the exemption is elected, then the deemed cost is translated into the first-time adopter's functional currency at the date of its determination.

2. Thereafter, the financial statements would be required to be presented in INR.

Consider this

It is to be noted that each entity in a group has its own functional currency. There is no concept of a group-wide functional currency under the accounting standards.

If an entity presents its financial statements in a presentation currency that is not its functional currency, then there is no requirement for it to present additional financial information in its functional currency.

In situations where an entity has to prepare both standalone financial statements and financial statements for submission to its group for consolidation, the functional currency for both would be the same, as determined as per Ind AS 21. However, for the purpose of consolidation, a company may translate its financial statements from its functional currency to another currency (as per the group reporting requirements) for consolidation purposes.