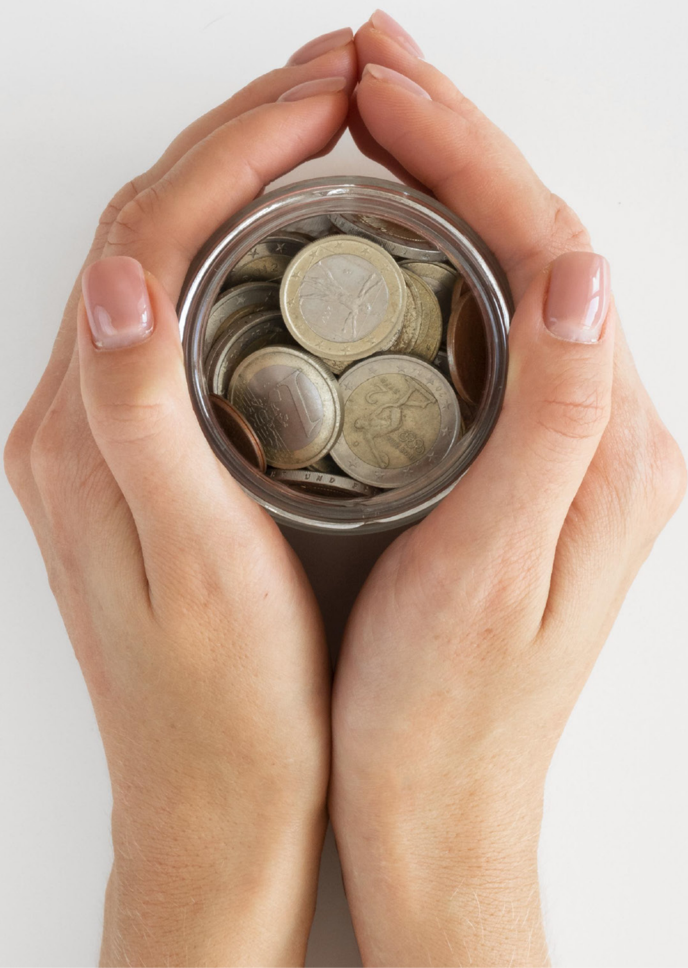
The effects of changes in foreign exchange rates



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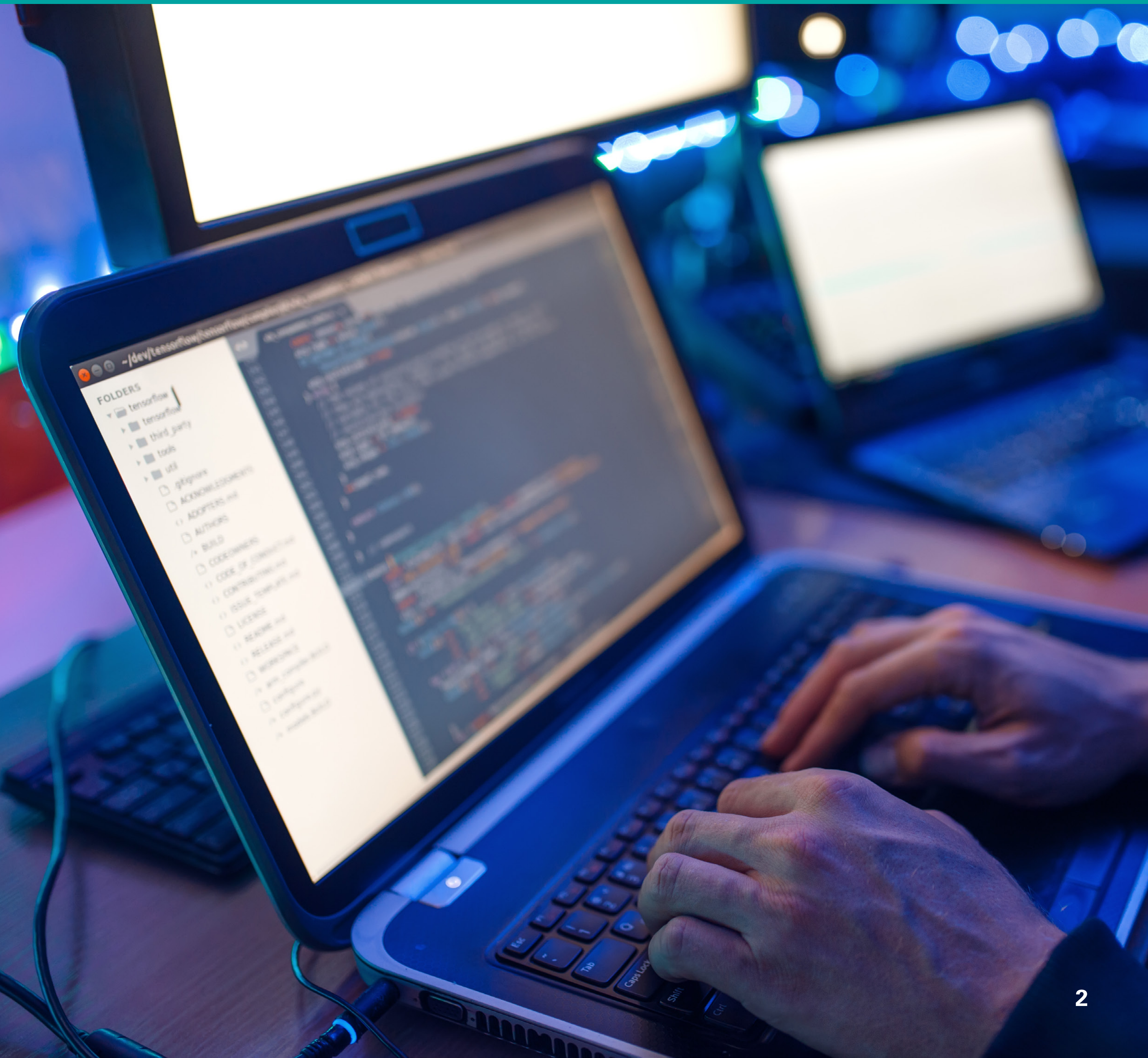
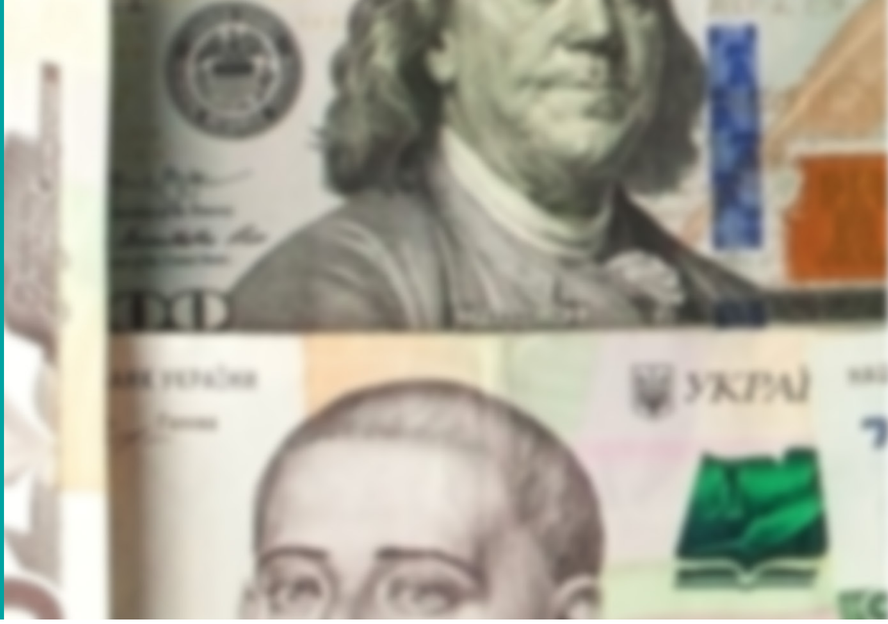
IAS 21 **The Effects of Changes in Foreign Exchange Rates** provides guidance to determine the functional currency of an entity under International Financial Reporting Standards (IFRS). The standard also prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements from the entity's functional currency into its presentation currency. This factsheet will delve into determining an entity's functional currency, determining the functional currency of a foreign operation, and dealing with a change in the said functional currency.



Definition and determination of functional currency



The functional currency is the currency in which an entity records and measures its transactions, in other words, the currency in which it maintains its accounting records. It is determined by reference to the **currency of the primary economic environment** in which that entity operates. To determine the functional currency an entity needs to consider various factors, which IAS 21 splits into 2 categories, that is the **primary** and the **secondary factors.**

The primary factors that an entity needs to consider are the following: -

(a) the currency that mainly influences the sales prices for the goods and services, which will often be the currency in which sales prices for its goods and services are denominated and settled;

(b) the currency of the country whose competitive forces and regulations mainly determine the sales price of its goods and services; and

(c) the currency that mainly influences labour, material and other costs of providing goods or services, which normally is the currency in which such costs are denominated and settled.

Very often, the application of points (a) and (b) above to gaming entities, does not give a straightforward interpretation of what that gaming entity's functional currency is. This is because a company with a gaming licence in a specific country, would have the facility to **operate in several different jurisdictions**, which could result in having revenues **denominated in various currencies.**

With respect to point (c), the management of the gaming entity would need to look at the location where its labour force is operating, the currency used to settle their respective salaries and any other costs it would be incurring.

The following secondary factors should also be considered to provide additional evidence of an entity's functional currency: -

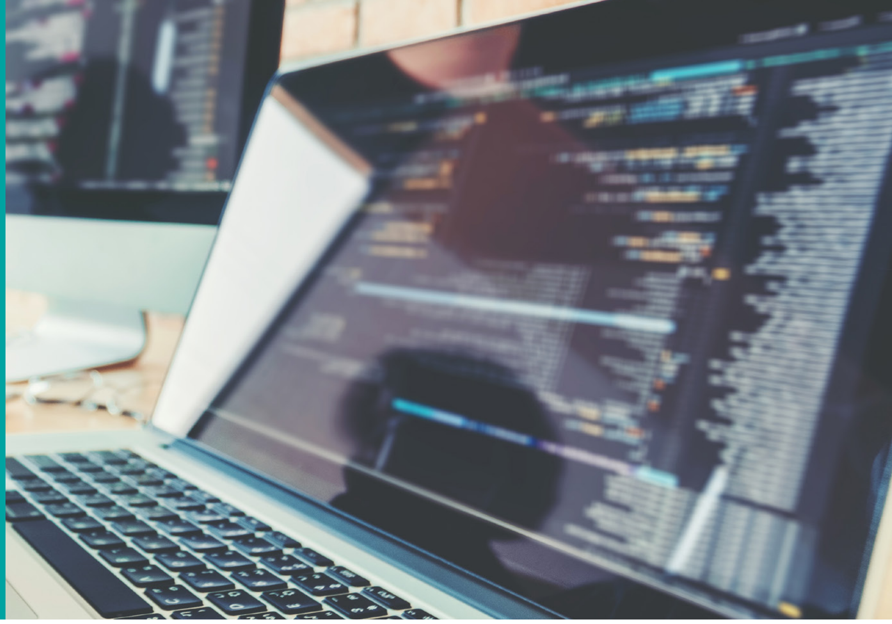
(a) the currency in which funds from financing activities are generated; and

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

In view of the fact that an analysis of the primary factors may not be definitive in determining the functional currency for a gaming entity, management is required to carry out an assessment taking also into consideration the above-mentioned secondary factors. Management is required to assess the funding obtained by the gaming entity and how the receipts from its operating activities are retained.

Therefore, to determine the functional currency of an entity management is required to carry out an assessment, taking into consideration the above mentioned primary and secondary indicators, which most faithfully represent the economic effects of the underlying transactions, events and conditions pertaining to the entity. When the above indicators are mixed and therefore do not give a clear indication of the entity's functional currency, management must exercise its judgement and, especially where gaming entities are concerned, give more weight to the secondary indicators.

Functional currency of a foreign operation



The term ‘foreign operation’ includes subsidiaries, associates, joint ventures or branches of a reporting entity, and which activities are based or conducted in a country or currency other than those of the reporting entity. IAS 21 requires an assessment to determine whether the foreign operation ‘inherits’ the reporting entity’s functional currency, or whether it has a functional currency in its own right.

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

Autonomy
Whether the operation is essentially an extension of the reporting entity.

Proportion of transactions
Whether the foreign operation’s transactions with the reporting entity constitute a high or low proportion of the operation’s activities.

Proportion of cash flows
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.

Debt service
Whether a foreign operation’s cashflow can service its debt obligations without funds being made available by the reporting entity.

Change in functional currency

As described above, an entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Hence, once determined, the functional currency does not change unless there is a change in the underlying nature of the transactions and relevant conditions and events. For example, a change in the currency that mainly influences the sales prices of the goods and services following a relocation of a significant component of the entity's business may led to a change in an entity's functional currency.

The effect of a change in the functional currency is accounted for prospectively. Therefore, an entity translates all items into the new functional currency using the exchange rate at the date of change. The resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit and loss until the disposal of the operation.

The responsibility to determine the functional currency lies with the entity's management, yet it is also the responsibility of the auditors to review critically and exercise professional judgement and scepticism, to ensure that the assessment made by management is appropriate and in accordance with IAS 21 principles.

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