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LKAS 21 – The Effect of Changes in Foreign Exchange Rates

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SCOPE OF THE STANDARD

This standard shall be applied,

(a) In accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are with in the scope of the financial instruments standard. (LKAS – 39)

SCOPE OF THE STANDARD (Contd…)

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

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

Functional Currency

Functional currency of an entity will be the currency that,

- ❖Influences the revenue of the entity
- ❖Influences the pricing policy of the entity
- ❖Influences the material, labour and other costs
- ❖In which finance is generated
- ❖In which receipts are retained

Functional Currency (Contd….)

Functional currency of an entity will be the currency that,

- ❖ Mainly influences the prices at which the entity sells its goods and services.

e.g. Big PLC is located in Sri Lanka, and the entire production of the Company is sold to overseas customers. The currency that mainly influences the prices at which it sells its goods and services is US dollars. Therefore the functional currency of the Company is US $ (Provided all other conditions are also satisfied).

Functional Currency (Contd….)

- **Influences the pricing policy of the entity.**
  In the above example international competitive forces mainly influence the pricing policy of Big PLC.

- **Mainly influences material, labour and other costs of providing these goods and services.**
  In the above example Big PLC mainly settles its costs in US $. It pays for the raw material it imports from Singapore in US $. Hence the functional currency of Big PLC is US $.

Functional Currency (Contd….)

- **In which finance is generated by the entity.**
  In the above example if Big PLC has raised finance through the shares and loans and are retained in US $. Hence the functional currency of the Big PLC is US $.

- **In which the receipts from customers is retained by the entity.**
  In the above example Big PLC receive cash in US $ and retain cash in US $. Hence the functional currency of Big PLC in US $.

Foreign operations of an entity

Foreign operations of an entity include any subsidiary, associate, join venture or branch which conducts business in a country or in a currency which is different from those of the reporting entity.

If the entity has any foreign operations then it has to consider a few additional factors while determining its functional currency.

Foreign operations of an entity (Contd….)

The additional factors are,

1. Whether the activities of the foreign operation are carried out as,
   - An extension of the reporting entity. In this case the functional currency of the reporting entity will be the functional currency of the foreign operation.
   - With a significant degree of autonomy. In this case the functional currency of the reporting entity may not be the functional currency of the foreign operation.

Foreign operations of an entity Contd....)

2. Whether the proportion of transactions which the foreign operations have with reporting entity is high or low.

3. Whether the cash flows from the activities of foreign operation.

   - Directly affect cash flows of the reporting entity and

   - Are readily available for remittance to it.

Functional Currency (Contd...)

When 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.

Functional Currency (Contd….)

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.

Definitions

- Foreign currency is a currency other than the functional currency of the entity.
- Presentation currency is the currency in which the financial statements are presented.
- Spot exchange rate – is the exchange rate for immediate delivery.
- Closing rate – is the spot exchange rate at the balance sheet date.

DEFINITIONS (Contd…..)

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. The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency.

e.g. Cash, bank balances, trade receivables

Non-monetary items – the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency.

e.g. Goodwill, Non current assets

Summery of the approach required by this standard

- In preparing financial statements, each entity – whether a standalone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) determines its functional currency.
- The entity translates foreign currency items into its functional currency and reports the effects of such translation.
- It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity presents its financial statements.
- This standard permits the presentation currency of a reporting entity to be any currency.

Reporting foreign currency transactions in the functional currency

Initial Recognition?

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency.

A foreign currency transaction shall be recorded, 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.

Reporting at subsequent balance sheet dates

At each balance sheet date,

(a) Foreign currency monetary items shall be translated using the closing rate.

(b) Non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction, and

(c) Non monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined.

RECOGNITION OF EXCHANGE DIFFRENCES

Monetary Items

The exchange difference is recognised in the statements of comprehensive income in the period in which the exchange difference arises.

RECOGNITION OF EXCHANGE DIFFERENCES (Contd.........)

There are a few exceptions to the general rule that exchange differences should be recognised in the statement of comprehensive income.

e.g.: When borrowing costs are capitalised as per LKAS 23 then any exchange differences are also capitalised and not recognised in the statement of comprehensive income.

RECOGNITION OF EXCHANGE DIFFERENCES (Contd…..)

Non Monetary Items

If gain or loss on non monetary items is recognised directly in equity. (e.g. Some gains or losses arising on a revaluation of PPE) then exchange component of that gain or loss is recognised directly in equity.

RECOGNITION OF EXCHANGE DIFFERENCES (Contd………)

If gain or loss on non monetary items is recognized in the statement of comprehensive income (e.g. Financial instruments measured at fair value through Profit or loss) then exchange component of that gain or loss is recognized in the statement of comprehensive income.

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. In other words, an entity translates all items into the new functional currency using the exchange rate at the date of change.

USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

Translation to the presentation currency

An entity may present its financial statements in any currency. If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency.

The results and financial position of an entity shall be translated into a different presentation currency using the following procedures.

(a) Assets and liabilities for each balance sheet presented including comparatives shall be translated at the closing rate at the date of that balance sheet date.

(b) Income & expenses for each income statement shall be translated at exchange rates at the dates of transactions.

(c) All resulting exchange differences shall be recognised as a separate component of equity.

DISCLOSURES

An entity shall disclose,

(a) 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; and

(b) Net exchange differences classified in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

DISCLOSURES (Contd……..)

(c) 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.

(d) 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.

DISCLOSURES (Contd……..)

When an entity presents its financial statements in a currency that is different from its functional currency, it shall describe the financial statements as complying with Sri Lanka Accounting Standards only if they comply with all the requirements of each applicable standards.

THANK YOU