Review

Proposed improvements to IAS 21 (The Standard)

Background

Entities to which The Standard will apply

In the modern commercial world exchange control regulations and reserve currencies are no longer as relevant as they were twenty-five years ago. Many more entities conduct operations in more than one currency, experiencing the associated accounting and difficulties and problems. Currency translation for reporting purposes still presents problems for accounting and auditing staff. Computer programs are written without the basic fundamentals or requirements being properly understood. Software architecture is not being designed to solve the problems in the most effective and user-friendly way. Reliance on memorandum accounts, which are not integral to the accounting system, is widespread. Subsidiaries or branches operating in countries where the local currency is different to that of the parent company are often expected to report in the currency of the holding company. Instructions are often issued by the accounting staff of the parent company on how the books and records are to be maintained and in what currency. Detailed instructions on end-accounting period reports are issued specifying the format of the reports and returns and the reporting currency to be used. Group accounting rates of exchange may also be issued for use in the preparation of such reports. Other stand-alone entities operate in economic environments foreign to their nationality and or their shareholders. At any one time they may have debtors and creditors as well as stocks and other assets and liabilities, both monetary and non-monetary, which are realisable, collectable or payable in a currency other than the one that is local to them. In these circumstances it is preferable that they should maintain not only good record of their foreign currency assets and liabilities but also of their open positions, historic, current and future or forward.

Occasionally an entity may be located in an area where there is a *de facto* currency in use. It is not the national/legal currency (*de jure*) of the locality. Usually in such circumstances the management decide to operate and keep the records in the former rather than the latter. For example an entity operating in Kosovo at present would almost certainly keep its records in Euros and not the local Serbian currency. Many International Non-Government Organisations (INGO's) such as The World Bank or FAO operate wholly in US dollars whatever the location of the operation. Very often in countries where the local/national currency is the currency of a hyperinflationary economy and has lost creditability, the local population will use another currency, in which they have more faith, as a parallel currency.

As a result of these changes some entities are using various multi-currency accounting (MCA) systems to maintain accounting books and records. Properly kept with integrity and according to good accounting principles, these fully balancing systems should operate without memorandum accounts. The use of them allows entities not only to monitor assets and liabilities in the currencies in which they were legally incurred and are legally collectable, but also to operate freely in those currencies, conducting trade in them and monitoring open positions if any. It is to be hoped that The Standard will do nothing to inhibit the development of such systems.

In many countries accounting laws and national charts of accounts enforce the methodology of keeping accounting books and records. In these countries all accounting books and records not only have to be drawn up according to the accounting code but have to be kept in the national (or local) currency. Another requirement usually found in such countries is that the accounting records have to be closed off at the end of an accounting period in absolute agreement with the published accounts. This usually means that the books are kept open until the accounts have been passed and accepted. The concept of reconciling the books to the financial statements via a working trial balance and associated working papers and records is usually unacceptable. Admittedly this enables the authorities to assess tax and other duties direct from the accounts instead of using a computational system as well as enabling them to collate national statistics on a uniform basis. However these situations neither encourage people of a high academic or management calibre to involve themselves in the accounting process nor does it encourage the development of sound accounting techniques. It is noticeable even now that in countries where there are, or have been until quite recently, rigid accounting laws and codes, accounting staff are still deficient in the skills and judgement which would enable them to develop flexible, secure and efficient accounting systems responsive to the changing environment in which they operate.

Objective and Scope, Definitions (1-14)

These paragraphs should be reconsidered in the light of what has been stated above and the definitions stated below.

<u>Definitions of terms used in this paper</u>

Where the definition of the words or phrases used in this paper are the same as that used in the Exposure Draft they have not been restated. Where definitions have been altered the alterations are in italics. Where a completely new term is used the definition is in normal type and underlined.

<u>Currencies</u>

<u>Functional Currency</u>

Any currency or currencies in which the entity operates and carries positions in monetary and non-monetary items

<u>Primary Functional Currency (PFC)</u>

<u>A functional currency designated to be the Primary functional Currency.</u>

Note

Where an entity keeps the accounting books and records in more than one functional currency, current accounting practice usually requires that a PFC will be designated into which all values of a trading nature should be transferred. (See

ITC below). This should be the currency into which the accounting records would be closed after the end of an accounting exercise. The decision on which currency should be the PFC would depend on a number of factors and in the case of a wholly or partly owned subsidiary would not necessarily be made locally. Usually it would be the currency of the primary economic environment in which an entity operates, and the currency that the local management wish to operate in, especially when measuring the value of any foreign currency positions, trading revenue, expenses and other costs. The guidelines used to decide which currency to designate as the PFC, would almost certainly be the same as those set out in paragraphs 7-12 of the Exposure Draft (Functional Currency). In an MCA situation it would only be a primary functional currency amongst other functional currencies and not the only currency of record.

Currency of Record

The currency in which an entity may be required by the laws of the state in which it operates to keep its books and records. It will almost always be the National Currency (see below).

National currency

The legal (de jure) currency of a country in which an entity is registered.

Foreign Currency

Foreign Currency is any currency other than the Currency of Record, or the National Currency.

Note

The term would probably not be used to describe a Parallel currency or a Local currency even though they might not be the National currency of the local economic environment. In an MCA the concept of Foreign Currency falls away with all currencies being functional or non-functional

Parallel currency

A foreign currency accepted in a locality that is not the national currency of that locality.

Note

This situation usually arises because the population and business community have lost faith in the national currency.

Local Currency

The currency accepted locally by the business community and the population. It may be either the National Currency or a Parallel Currency.

Presentation Currency

Presentation Currency is the Currency or Currencies in which the financial statements are presented or any currency or currencies in which an entity is required to produce financial statements and/or financial reports for consolidation or part consolidation.

Note

It is quite possible that an entity will need to produce Financial Statements in more than one presentation currency. For example a subsidiary of a US group, incorporated in Hungary will be required to produce Financial Statements in the national currency of Hungary (Forints) for registration and tax purposes and it will also be required to produce financial reports in US dollars for consolidation into the group accounts. It may also be required to produce financial statements in either or both for public consumption.

Exchange Rates

General

Rate of Exchange - The ratio for exchange for two currencies.

Note

This definition is unchanged from that stated in the IAS but has been repeated because the following definitions are based on it.

Specific

Spot Rate

The exchange rate for immediate delivery.

Note

This definition is unchanged from that stated in the IAS but has been repeated because the following definitions are based on it.

Comment

For accounting purposes the rate used should be the middle market rate, (MMR) i.e. the rate at the mid point between the buy and sell rate. This will usually be obtained from the free exchange markets or, in a controlled economy from the delegated authorities

Closing Rate (CR) – *the MMR at the close of business on a recognised market in the local economic environment applicable to the entity.*

Reporting Date Rate (RDR)– The Closing Rate at the date of any reports or statements used in the preparation of the Financial Statements.

Transaction Date Rate (TDR) – The Closing rate at the date of a transaction.

Average Closing Rate (ACR) – The average of closing rates for a given period.

Note

The definitions used for the various rates of exchange focus attention on the various methods that may be used in translation for accounting purposes.

Consideration should be given however to the definition of CR. It might be considered useful to give more guidance on, for example when and where the relevant rates are acceptable. A subsidiary of a US company Operating in Eastern Europe might have the choice of the rate quoted locally at local time or the rate in the US at a much later hour and a materially different rate. The above definition limits the CR to that quoted on a recognised market local to the entity but this point appears to be open to discussion. Whatever rate is used it should be clearly stated in the accounts how it has calculated. See notes on Disclosure 49-55(below).

Other Definitions

Currency Exchange Transaction (CET)

A physical exchange of currency with another entity, in which one currency is bought or sold for a consideration denominated in another currency.

Multi-currency Accounting (MCA)

A system of accounting whereby the books and records are kept in more than one functional currency. Each currency balances within the system and the whole integrated system balances through position accounts.

Position

A situation where there is a mismatch of assets and liabilities in any currency. Where a position is open and uncovered there is therefore an exposure to a possible profit or loss resulting from any fluctuation in the currency.

Translation

The expression of financial data denominated in one currency in terms of another by reference to the relevant rate of exchange.

Inter-currency Transfer (ICT)

A transfer of value between currencies via position accounts.

Note

MCA - It is now quite possible to run an MCA system without a designated PFC. By holding all the data on a comprehensive multi-currency database and using powerful report writing software, reports can be written in any Presentation Currency required. This may be a step too far for some at present but it should be recognised as a probable development in accounting practice.

Translation - The definition used for Translation clearly states the nature of Translation. It should not be confused with an Inter-currency Transfer (ICT), which is internal transfer of value from one currency to another in a multi-currency accounting context, or a Currency Exchange Transaction (CET), which is a conversion of one currency into another via a third party,

Position - The monitoring of open positions is now as vital for purely commercial entities as it has been in the past for entities involved in currency dealing. It is to be hoped that this can be achieved by including within the accounting architecture simple integrated accounting techniques that will enable this to be done in real time and accurately.

Summary of the Approach required by (this) Standard (15-17)

Comment

If it is accepted that the Summary will apply both to entities running multi-currency accounting systems, as well as to entities required to account using COR systems, then the Summary should be "adjusted" to reflect this situation.

Reporting Foreign Currency Transactions in the Functional Currency (18-20)

Comment

Paragraph 19 should be adjusted to reflect the reality that foreign currency transactions are not necessarily wholly recorded on initial recognition in the functional currency. This would be true of an accountancy system run on the COR system. It would not usually be true in an MCA system, where the value of the elements of a transaction applicable to the statement of Income and Expenditure would probably be transferred into the PFC records using an ITC but the elements applicable to the Balance Sheet (monetary and non-monetary items), would remain in the currency in which they had been acquired incurred or were to be settled.

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Reporting at Subsequent Balance Sheet dates (21-24)

No comment other than on the point made in the last sub paragraph of paragraph 23.

In an MCA or a COR system, all charges against assets or provisions for the repayment of liabilities, which accrue on a daily basis such as depreciation, lease amortisation, or provisions for loan repayment, should be initially recognised in the currency in which the asset or liability is denominated. In a COR system the simplest practice will be to translate the charge into the COR at the average rate for the period in question. However it may be required practice to use the historic rate, being the rate ruling at the date of acquisition of the asset or the incurring of the liability. In an MCA system an ICT would transfer the charge into the PFC by reference to the historic rate of the asset or liability. Where the historic rate is used, in either system, a further charge may be necessary where the charge calculated at the historic rate is less than the charge calculated at the average rate for the accounting period in question. Where this situation occurs the adjustment could either be put through only in the PFC or the COR, building up a reserve or an additional provision. In an MCA this reserve or provision could be built up in the currency of the asset or liability. In any case a note to the Financial Statements should state clearly the treatment of such items and the amounts involved.

The Point made in Paragraph 24 needs development. (See the comments above on the various Exchange Rate definitions) Where several exchange rates are available there will be a choice. The decision as to which rate was used needs to be justified in the financial statements. In countries where a two-tier currency is in operation for exchange control purposes, and an entity has positions in either or both tiers, the rate used for reporting purposes should be the RDR or the ACR for whichever tier of currency is applicable to the balances being translated. However the comments applicable to the choice of MMR still should apply. (See above) In an MCA system the tiers would be accounted for as though they were separate currencies.

Recognition of Exchange Differences (25-32)
No comment

Change in the Functional Currency of an Entity (33-35)
Comment
These paragraphs are more relevant to COR systems. If, in an MCA system, the PFC were to be changed, it would only be necessary to move all balances in the previous PFC into the new PFC using an ICT. The MMR used would be the one ruling between the two currencies at close of business on the date of change. (See comment on paragraph 52)

Use of a Presentation Currency other than the Functional Currency (36-41)
No comment

Translation of a foreign Operation (42-45)
Comment
Following the acquisition of a foreign entity there may be an adjustment to the carrying amounts of assets and liabilities. These adjustments should be made in the same currency as that of the assets and liabilities and depreciation adjusted accordingly. (See comments on paragraph 23 above.) A goodwill adjustment may be made on the acquisition of an entity but it should appear in the records of the acquiring entity in the currency in which it was originally recognised and depreciated accordingly. (See comments on A25 below.)

Disposal of a Foreign Operation (46 & 47)
No comment

Tax Effects on All Exchange Differences (48)
No comment

Disclosure (49-55)
Comment
Entities should disclose additionally the accounting policies followed in deciding which types of Exchange Rates were applicable to which items in the Translation Exercise. They should also disclose on which markets the relevant MMR's were quoted. (See comments on Definitions of Exchange Rates above). Consideration

should also be given to requiring disclosure of any material Open Positions at the Accounting Date.

Where there has been a change in COR or PFC (Para 52) this should not only be disclosed, but the reasons for the change given. The note should also state if any material differences would have occurred if the last set of comparative figures and all movements since the date of those figures had been reworked using the new currency.

Effective Date (56)

No comment

Invitation to Comment

Question 1
No. See comments, definitions and preamble. In an MCA it would be more the definition of the PFC.

Question 2
Yes – This is essential provided that the requirements of the Standard are closely heeded.

Question 3
Yes as per A15

Question 4
Yes as per A20

Question 5
a) Goodwill arising on the acquisition of a foreign entity should appear in the records of the acquiring entity in the currency in which it was originally recognised, which may not be a currency in which the acquired entity functions. It should remain in the acquirer's books and be depreciated accordingly in that currency – see comments above on depreciation. (A25) It arises because the acquiring entity places a higher value on the acquired entity than can be explained in net balance sheet terms. It may be the result of group strategy or some other reason known only to those who made the acquisition. In such circumstances it is surely preferable that such an intangible asset is treated as an asset of the parent and not 'pushed down' to a lower level.
b) Following the acquisition of a foreign entity there may be an adjustment to be made to the carrying amounts of assets and liabilities. These adjustments should be made in the books and records of the acquired entity in the same currency as the relevant assets and liabilities are carried in the depreciation adjusted accordingly. (See comments on paragraph 23 above.)