Classification of foreign exchange differences on intercompany borrowings

Background

1. IFRS 18 includes certain requirements (see paragraph B65 of IFRS 18) on the classification of foreign exchange (FX) differences included in the statement of financial performance. FX differences might arise, for example, in the separate financial statements of a subsidiary when a parent entity provides an intercompany loan denominated in the parent's functional currency to its subsidiary and the subsidiary's functional currency differs from that of the parent.

2. Such FX differences may also arise in the parent's separate financial statements when the parent provides a loan in the subsidiary's functional currency and when the functional currency of the parent is different to that of the subsidiary.

3. IFRS 18 does not provide explicit guidance on the classification of FX differences that remain in the consolidated financial statements even though the underlying intercompany transaction is eliminated.

4. Assume that the intercompany balances are not related to working capital (when any foreign exchange would be classified in the operating category upon consolidation) and are also not considered net investments in the subsidiary (when any foreign exchange would be classified in OCI upon consolidation). The intercompany loan arises from a transaction that involves only the raising of finance in the separate financial statements of the entity that receives the cash.

5. Through this submission we are aiming to clarify which treatment would be acceptable when classifying FX differences on intercompany loans in the consolidated statement of financial performance when the underlying asset and liability are eliminated on consolidation.

6. Even though IFRS 18 is not yet effective, we ask the IFRS Interpretations Committee (IFRS IC) to consider this application question based on paragraph 5.16 of the IASB's Due Process Handbook due to the following:
    a. Intercompany transactions, particularly intercompany loans in foreign currencies, are likely to be encountered across multinational groups. The resulting FX differences that remain in the consolidated financial statements are often material and affect a broad range of IFRS preparers.
    b. IFRS 18 does not explicitly address the classification of such FX differences in consolidated financial statements when the underlying intercompany transaction is eliminated. We think this lack of guidance will lead to inconsistent application and reduced comparability because we are aware of

preparers currently concluding that the guidance is not clear as they work through their implementation projects. Many of these preparers acknowledge that the default category under IFRS 18 is the operating category. However, this seems to be counterintuitive when the business rationale for intercompany funding is financing and most IFRS reporters present the forex on these arrangements in the financing category under IAS 1.

c. The issue can be addressed within the scope of IFRS 18, particularly paragraph B65, which provides a principle for classifying FX differences. Therefore, a narrow clarification, specifically with regard to such FX differences in consolidated financial statements when the underlying intercompany transaction is eliminated, would be sufficient without requiring further amendments to the standard.
d. The issue is narrowly defined—limited to FX differences on intercompany loans eliminated on consolidation—but has significant implications for financial reporting consistency and system implementation.

7. In addition, given the absence of a Transition Resource Group (TRG) for IFRS 18, we request the IFRS IC to address this issue.

Question and views

How should the FX differences arising on intercompany borrowings be classified in the consolidated financial statements?

View A - Based on the category in the separate financial statements

8. The FX differences in the consolidated financial statements should follow the same classification as in the separate financial statements where the foreign exchange difference arose.

9. As per paragraph B65 of IFRS 18, an entity should classify FX differences included in the statement of financial performance, applying IAS 21, in the same category as the income and expenses from the items that resulted in the FX differences unless doing so would involve undue cost or effort. Notwithstanding that the assets and liabilities are eliminated on consolidation, that does not alter the fact that the underlying FX differences arose from the related asset or liability.

10. If, for example, the FX difference is classified in the subsidiary's separate financial statements in the financing category, the FX difference would also be classified in the financing category upon consolidation. Similarly, if the FX difference arises in the entity that provided the financing, the FX difference would be presented in the investing category upon consolidation.

View B - Financing category

11. From a consolidated perspective, the group considers the overall nature of the transaction to be one that results from only the raising of (intercompany) financing. Therefore, upon consolidation, the FX difference will be classified in the financing category, irrespective of which entity in the group provided the loan.

View C - Investing category

12. On a consolidated level it can be argued that the FX difference arises due to the transfer of cash from one currency into another currency for a period of time. The group is exposed to the FX difference because of the transfer of cash for a period of time.

13. As per paragraph 53 of IFRS 18, income and expenses from cash and cash equivalents should be classified in the investing category, unless the entity has a specified main business activity.

View D - Operating category

14. The operating category is the 'residual' category for income and expenses and there is no related underlying transaction on consolidation.

15. The FX difference cannot be classified in the same category as the income and expenses from the items that resulted in the FX difference as the item (i.e. the intercompany borrowing) does not exist in the consolidated financial statements.

16. Therefore, the classification of this item defaults to the operating category in the consolidated statement of financial performance.

View E – Accounting policy choice

17. IFRS 18 has no explicit guidance on the classification of FX differences on intercompany borrowings which are eliminated on consolidation. All of the above views have merit based on IFRS 18 and, therefore, any of the above approaches will be acceptable for the classification of the FX differences. The accounting policy should be applied consistently.