Project	**IAS 21 The Effects of Changes in Foreign Exchange Rates**
Topic	**Tentative agenda decision – Determining the functional currency of an investment holding company**

Introduction

Objective of this paper

1. The IFRIC received a request for guidance on determining the functional currency of an investment holding company. The full text of the IFRIC request received has been included in Appendix A.

2. The objective of this paper is to document the staff's analysis and recommendation on the issue. As such, this paper:

   (a) provides background information on this issue;

   (b) analyses the alternatives;

   (c) provides preliminary agenda criteria assessment;

   (d) makes a staff recommendation on the tentative agenda decision; and

   (e) asks the IFRIC whether they agree with the staff recommendation.

Background

3. There are divergent practices in particular jurisdictions for determining the functional currency of a stand-alone, listed investment holding company ('holdco'), where the holdco is established outside the jurisdiction(s) in which its subsidiaries operate.

4. The request is for the IFRIC to give clarity on whether the underlying economic environment of subsidiaries should be considered in determining the functional

currency of the stand-alone financial statements of the investment holding company.

Technical Analysis

Determining the functional currency of the holdco

5. The submission describes two views:

   View A: the holdco uses the currency of *its local environment* as its functional currency – this is the currency in which its operating expenses are denominated, in which it receives dividends from its subsidiaries, and is the currency in which it raises funding.

   Or

   View B: the holdco uses the currency of the *local environment of its subsidiaries* as its functional currency, as this is the environment driving the dividend income the holdco receives, which is its primary source of revenue.

6. IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires each individual entity to determine its functional currency and measure its results and financial position in that currency. Each individual entity within a group determines its own functional currency – there is no such concept as a group functional currency.

7. IAS 21 paragraph 8 states that ‘The functional currency of an entity is the currency of the primary economic environment in which the entity operates’.

8. The *primary economic environment* is the environment in which the entity primarily generates and expends cash (IAS 21.9). The functional currency is often the currency of the country in which the entity is located, but it may be a different currency.

9. IAS 21 requires entities to consider primary and secondary factors when determining its functional currency, and to apply judgement to the facts and circumstances at hand. Primary factors are closely linked to the primary economic environment in which the entity operates and are given more weight. Secondary factors are persuasive in determining an entity’s functional currency. Appendix B includes these primary and secondary factors, as extracted from

IAS 21. The staff analysis below will consider these factors in respect of the submission.

Foreign operations

10. The submission notes that 'there is no scope within paragraphs 9 to 14 of IAS 21 for an investment holding company to be viewed as an extension of its subsidiary (i.e. the attribution of a functional currency from one group entity to another in accordance with paragraph 11 only applies in a downwards direction i.e. from parent to subsidiary (or other investee) and not vice versa).'

11. The staff think this point is worth considering. Paragraph 11 relates to determining the functional currency of a foreign operation[1] by reference to the functional currency of its holding company. By analogy then, could the determination of the functional currency of a holding company be influenced by the functional currency of its foreign operation(s)?

12. Paragraph 11 of IAS 21 specifies 4 factors that should be considered in determining the functional currency of a foreign operation, and whether it should be the same as that of the reporting entity. These factors are included in Appendix B. Generally, if a holdco and its subsidiaries have a high level of integration in the way they operate, frequent intercompany transactions, and a material degree of co-dependency of cash flow and funding, it may make sense for the reporting entity and its subsidiaries to have the same functional currency.

Staff analysis

13. An investment fund entity or holdco carries out operating activities of its own, albeit not in a traditional trading manner. It holds and manages subsidiaries (and other investments) – that is its main business.

14. IAS 21.12 requires management to use 'judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions'. Applying the primary and secondary factors in IAS 21 may not clearly determine a functional currency for a holdco type of

[1] A foreign operation is 'an entity that is a subsidiary/associate/joint venture or branch of the reporting entity, the activities of which are based or conducted in a country or currency other than that of the reporting entity' (IAS 21.8)

entity. The factors are directed towards manufacturing entities providing goods and services. Investment fund entities are service-related entities. They tend to have small operating expenses, and earn the majority of their revenue as dividends from their investments. Further, paragraph 36 of IAS 21 states that once a functional currency has been determined, it should not be changed unless there is a change to the underlying transactions, events and conditions that determined the functional currency in the first place.

15. In respect of the foreign operation argument (paragraphs 10 - 12), consider the case where a holdco has subsidiaries in different economic jurisdictions, each with different functional currencies. It is entirely possible that one subsidiary could declare materially more dividends than its fellow subsidiaries (therefore having the greatest impact on the holdco's revenue) in any given year, if it performs better than the others. Following the reasoning above, would it then be fair to say that the holdco should have the same functional currency as that subsidiary, given that this could change in the following financial year, when another subsidiary with another functional currency declares the largest dividend?

16. The staff think that it was not the intention of IAS 21 for the functional currency of an entity to change annually, or even regularly. The staff thinks that an application of the indicators in IAS 21.11 by analogy in an 'upstream' manner may have this effect. Apart from confusing the user of the financial statements, the cost-benefit of regularly switching functional currencies would need to be considered. This is one of the reasons that the standard does not deal with the concept of a group functional currency (refer to the discussion in BC12 of the standard).

17. The staff think a holdco entity that is carrying out operating activities and making management decisions in its local currency, that is raising finance in its local currency and that has a significant degree of autonomy from its subsidiaries in the way its business is managed, all point towards View A. The staff emphasise though, that all facts and circumstances must be taken into account in applying the necessary judgement to determine the functional currency of an entity.

Agenda criteria assessment

18. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *Is the issue widespread and practical?*
    The submitter of the query states that the issue is commonly seen where a holdco and its subsidiaries operate in different jurisdictions. They also asked other national standard setters if the issue had been observed in their jurisdiction. One national standard setter responded to say that they had observed diversity between view A and B in their jurisdiction. The other two who responded had sympathy with the issue but had not observed diversity of practice in their regions.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
    As the submission indicates, there could be some degree of divergence in practice when financial statements of a holdco are prepared on the basis of either view A or view B.

    (c) *Would financial reporting be improved through elimination of the diversity?*
    Financial reporting may be improved if diversity of treatment was eliminated, however IAS 21 is clear in acknowledging that judgement will be required in its application. Diversity is therefore always likely to exist in matters such as these.

    (d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*
    The staff think the issue is too narrow to develop an interpretation. Any guidance provided would be application guidance issued in the form of indicators to consider in determining the functional currency of an investment holding company type of entity.

    (e) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the*

IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)

There is no current IASB project dealing with this issue.

19. Based on the assessment of the agenda criteria in paragraph 18, the staff recommends that IFRIC not add the issue to its agenda. The proposed wording for the tentative agenda decision is set out in Appendix C.

Question 2 for the IFRIC
1. Does the IFRIC agree that the issue should not be added to the agenda? 2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision in Appendix C?

Appendix A – IFRIC potential Agenda Item request

A1. The staff received the following IFRIC agenda request. All information has been copied without modification by the staff.

A2. [XXXX] request IFRIC to address the following issue with respect to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, relating to the determination of the functional currency of an investment holding company.

The issue

A3. IAS 21 requires each entity - whether a standalone entity, an entity with foreign operations or a foreign operation – to determining its functional currency. IAS 21 defines the functional currency of an entity as the currency of the primary economic environment in which it operates.

A4. IAS 21 paragraph 9 states that the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. Specifically, IAS 21 paragraph 9 requires an entity to consider (a) the currency that influences sales prices for goods and services; (b) the currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods or services and (c) the currency that influences labour, material and other costs of providing goods and services.

A5. Paragraphs 10 and 11 of IAS 21 provide further guidelines on additional supporting evidence that an entity can consider when determining the functional currency.

A6. In some situations, the indicators in IAS 21 paragraph 9 may not be helpful in determining the functional currency of an entity. For example, for an investment holding entity that does not undertake any material operating activities of its own, the consideration of the currency that mainly influences sales and cost of sales is not directly relevant. Current IAS 21 does not provide direct guidance on how to determine the functional currency of such holding entities.

Current practice

A7. Through a review of listed companies' financial statements in Hong Kong, we observe that there are two distinct approaches in determining the functional currency of investment holding companies which have some common facts as below:

(a) The investment holding company (i.e. the listed company) is incorporated in Hong Kong or elsewhere (eg the Cayman Islands and Bermuda) with its shares listed on the Hong Kong Stock Exchange;

(b) The ordinary share capital and the borrowings of the investment holding company are all denominated in Hong Kong dollars (HKD);

(c) The investment holding company incurs some administrative and local expenses, comprising mainly directors' emoluments, limited staff costs and office rental payments, which are settled in HKD;

(d) The principal assets of the holding company are its investments in subsidiaries. All of the operating subsidiaries of the holding company operate in Mainland China and their functional currency is Renminbi (RMB). Any dividend income received from the subsidiaries is either received in HKD or converted into HKD on receipt as the holding company does not have any RMB liabilities and, due to currency restrictions over the RMB, has very limited ability to hold RMB cash deposits.

A8. One view would be that the functional currency of the holding companies is to be determined as HKD. The proponents of this view note that there is no scope within paragraphs 9 to 14 of IAS 21 for an investment holding company to be viewed as an extension of its subsidiary (i.e. the attribution of a functional currency from one group entity to another in accordance with paragraph 11 only applies in a downwards direction i.e. from parent to subsidiary (or other investee) and not vice versa). Instead, for the purposes of identification of functional currency in accordance with paragraph 17 of IAS 21, it is necessary to view the investment holding company as either a stand-alone entity within the group, or as an extension of its investors. Either way, in this particular fact pattern HKD would be identified as the functional currency, since it is the currency in which all its operating expenses (small though they may be) are denominated and the currency of its sources of financing. The currency of Mainland China, the RMB, is not considered to be the functional currency of the investment holding company as it does not itself operate in Mainland China and carries its investments in the operating subsidiaries at cost. Furthermore, in accordance with paragraph 11(a) of IAS 21, the operating subsidiaries are regarded as foreign operations of the investment holding company as these subsidiaries accumulate cash and other monetary items, incur expenses, generate income and arrange borrowings all substantially in their own local currency of the RMB with a significant degree of autonomy.

A9. the supporters of this approach also note that such investment holding companies frequently exist to hold investments within jurisdictions with restricted currencies, such as the RMB. In their view it would seem appropriate to identify a restricted currency, such as the RMB, as the functional currency of an entity when that entity is itself legally unable to hold the currency and would incur operational costs if settling transactions denominated in that currency due to the need to enter into foreign exchange trades.

A10. an alternate view would be that RMB is a more appropriate functional currency for such an investment holding company given that its primary source of income (being dividend from its operating subsidiaries) is from Mainland China and its ability to service debts and make distributions to its owners are heavily dependent on the economy of Mainland China. This approach is considered by its supporters to be consistent with the provision in paragraph 12 which states that the entity needs to consider the primary factors stated in paragraphs 9 of IAS 21, before going down to the indicators stated in other paragraphs of IAS 21. In the context of an investment holding company the assessment of income, as required by paragraph 9(a), would be the dividend income to be received from its operating subsidiaries.

A11. Furthermore, the currency in which dividends from subsidiaries are denominated of itself is not a conclusive factor in determining the functional currency of an investment holding company. Paragraph IN7 in the introduction to IAS 21 makes clear that the Standard gives greater emphasis to the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated. Investment holding companies control their subsidiaries and thus may ask for dividends to be paid in whatever currency they like. The currency in which dividend income is denominated is therefore not relevant in determining the functional currency of an investment holding company, as the amount of the dividend income is determined by the currency of the income of subsidiaries (eg the RMB) and retranslated into the settlement currency. Likewise, management should not determine the functional currency of an investment holding company solely based on the currency in which funds are invested in the subsidiaries.

A12. The Institute does not consider that IAS 21 provides clear guidance on whether the underlying economic environment of subsidiaries should be considered when determining the functional currency of an investment holding company. The Institute therefore requests that the IFRIC consider issuing an interpretation to give clarity.

A13. Reasons for the IFRIC to address the issue:

(a) Is the issue widespread and practical?

The notion of a group-wide functional currency does not exist under IFRS. Many multinational groups have found the process of assessing the functional currency time-consuming and challenging, particularly when considering non-trading investment holding companies where the standard's emphasis is on external factors. A significantly different accounting result will be achieved if a different functional currency is chosen based on divergent interpretations. For example, the decision made on the functional currency will affect the recognition and measurement of convertible instruments in the financial statements. Where a convertible bond is denominated in a currency other than the functional currency of the entity, the fixed-for-fixed conditions would not be met and the conversion feature in the convertible instrument should be classified as a liability instead of as equity. The issue is commonly seen where an investment holding company is established outside the jurisdiction of its principal operations, such as in Hong Kong, Singapore, Cyprus, British Virgin Islands, Bermuda and the Cayman Islands.

(b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

We refer to the comments as outlined above. Diversity in practice is observed in determining the functional currency of an investment holding company. The differing views are on whether the currency of the primary economic environment in which the investment holding company's subsidiaries operate should be considered

(c) Would financial reporting be improved through elimination of the diversity?

Financial reporting would be improved by providing an interpretation which would lead to a consistent approach to ensure comparability among companies' financial reporting.

(d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the *Framework for the Preparation and Presentation of Financial Statements*, but not so narrow that it is insufficient to apply the interpretation process?

We are of the opinion that the scope of the issue is appropriate to be addressed by an interpretation of IFRIC, as it pertains to the application of the principles in paragraphs 9-12 to an investment holding company.

(e) If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than IFRIC would require to complete its due process).

We are not aware that there is any current or planned IASB project relating to the determination of the functional currency of an investment holding company.

Appendix B – Extracts from IAS 21 showing the indicators applied in determining the functional currency

Functional currency of an entity

B1 IAS 21.9 presents the **primary factors** for determining a functional currency of **an entity**, as depicted in the table below:

Indicators	**Factors to be considered by the entity**
Sales and cash flows	▪ The currency that *mainly influences* sales prices for its goods and services, and ▪ The currency of the country whose competitive forces and regulations *mainly determine* the sales prices of its goods and services.
Expenses	The currency that *mainly influences* labour, material and other costs of providing goods and services. This is often the currency in which the costs are denominated and settled.

B2 Paragraph 10 of IAS 21 provides **secondary factors** of the functional currency of **an entity**, as follows:

Indicators	**Factors to be considered by the entity**
Financing activities	Currency in which funds from financing activities are generated, e.g. issuing debt and equity instruments.
Retention of operating income	The currency in which receipts from operating activities are usually retained (currency in which the entity maintains its excess working capital balance).

Functional currency of a foreign operation

B3 Paragraph 11 of IAS 21 specifies 4 additional factors that should be considered in determining the functional currency of a **foreign operation**, and to assess whether it should be the same as that of the reporting entity (in this case, the reporting entity would be the holdco). These are as follows:

Factors	**Factors supporting functional currency of the foreign operation *being different* from that of the reporting entity**	**Factors supporting functional currency of the foreign operation *being the same as* that of the reporting entity**
Degree of autonomy	Activities carried out with a significant degree of autonomy; operational activities carried out in local currency	No significant degree of autonomy, activities are carried out as an extension of the reporting entity, e.g. the foreign operation sells goods on behalf of the reporting entity and remits the proceeds to it
Frequency of transactions with reporting entity	Few inter-company transactions between the entities	Frequent and extensive inter-company transactions between the entities
Cash flow impact on the reporting entity	Mainly in local currency; do not affect reporting entity cash flows	Directly impact the reporting entity cash flows, funds readily available for remittance to reporting entity
Financing	Cash flows from the activities of the foreign operation are sufficient to service its debt requirements	Reporting entity provides significant funding in order for the foreign operation to operate

[Appendix C is omitted from this observer note]