



Staff Note

Date **Month, Year**

Contact(s) **Wayne Upton** wupton@iasb.org +44 (0)20 7246 6449

Project **International Director**

Topic **Foreign Currency Discussions**

Introduction

1. Recent economic developments have focused attention on the requirements of IAS 21, *The Effects of Changes in Foreign Exchange Rates*. In this paper, I have tried to capture issues that people have raised with me about the accounting for foreign exchange transactions. Some of those are not directly linked to IAS 21. They reflect the interaction between foreign exchange and other standards.
2. IAS 21 has been a fairly durable standard, and none of the topics discussed in this paper grow from misunderstandings about its requirements. Indeed, the IFRIC list of rejected agenda topics lists only one IAS 21 item. However, the IFRIC has dealt with several issues that involve the interaction between foreign currency and other issues, most notably IAS 32 and 39.
3. Much of the recent attention to IAS 21 comes from the experience of countries during the financial crisis. As background to this analysis, I collected daily exchange rates between the U.S. dollar and eight other countries. The period covered was 1 January 2006 to 15 November 2009. The table below summarises the result.

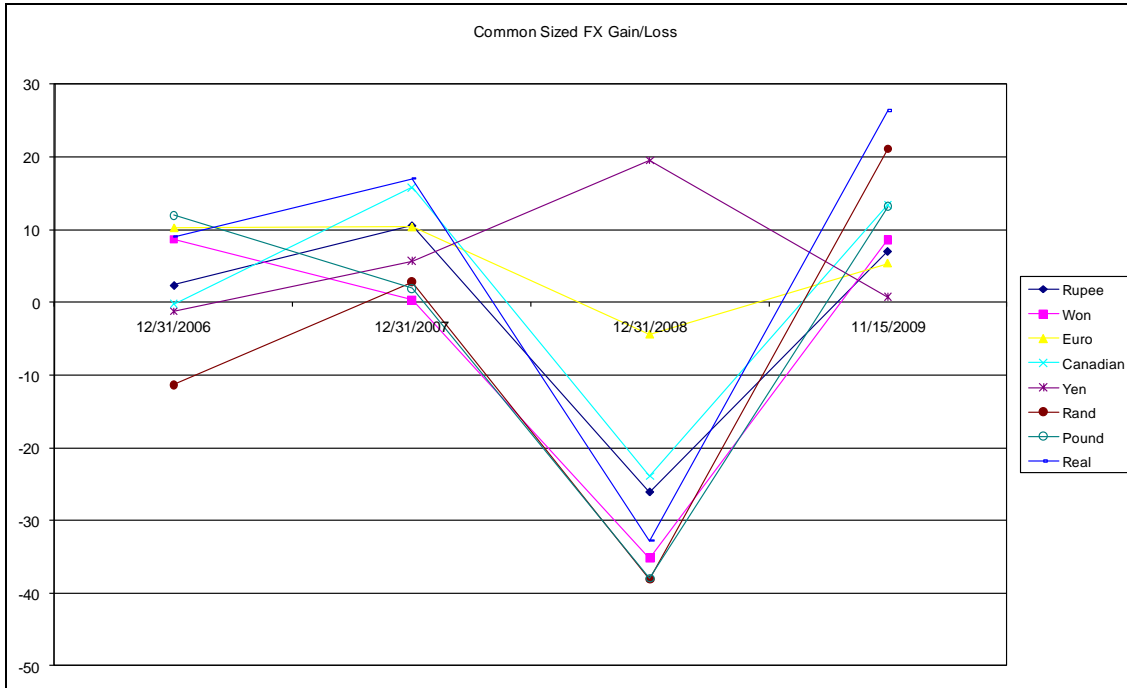
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Summary of Exchange to U.S. Dollar									
	Rate at		During the period						
	1-Jan-06	15-Nov-09	High	Low	Range as %	Mean	Standard Deviation	as a % of mean	
Brazilian Real	2.3517	1.7341	2.6547	1.5605	54.63%	2.002891	0.22821	11.39%	
Canadian Dollar	1.1641	1.0532	1.2928	0.9145	34.21%	1.105897	0.078885	7.13%	
Euro	0.8446	0.6712	0.8451	0.6269	29.72%	0.734283	0.055107	7.50%	
Indian Rupee	45.195	46.2	53.7639	39.275	32.36%	44.77183	3.651574	8.16%	
Japanese Yen	117.681	89.6858	123.962	88.2351	32.96%	108.406	10.26073	9.47%	
South African Rand	6.3359	7.464	11.4773	5.9847	71.81%	7.649148	1.085213	14.19%	
South Korean Won	1028.7	1156.34	1569.61	899.69	62.69%	1068.658	168.1486	15.73%	
United Kingdom Pound	0.5802	0.5999	0.7283	0.4751	45.57%	0.555597	0.064017	11.52%	

4. The table suggests that currency volatility is not a problem unique to emerging and transitional economies. Brazil, South Africa, South Korea, and notably, the United Kingdom clearly separate from the others. India's Rupee is only slightly more volatile over the period than the Euro.
5. Of course, different starting and ending points would change the results of any analysis like this one. As it happens, 31 December 2008 was near the low point for several of these currencies. To demonstrate the effect, I computed the foreign currency gain or loss from a loan of US\$ 10,000, made on 1 January 2006. I then placed the gains and losses on a common size basis, with the following result. The chart is cluttered, but the message is clear. All of the currencies except the Euro and the Yen showed large losses.

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Topic 1 – Rates and current recognition

6. IAS 21 specifies the rates used to translate assets, liabilities, income and expense. Companies frequently borrow in reserve currencies like US dollars or Euros (RC), but their functional currency is the local currency (LC). They use the proceeds of the borrowing to acquire fixed assets. Those assets are located or based in the home jurisdiction.
7. In subsequent measurement, the debt is translated at the current spot exchange rate, because the debt is a monetary asset. The asset is translated at the historical exchange rate. Changes in the spot rate applied to the debt produce gains or

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losses that are reported in profit or loss. Constituents have raised several objections to this result:

- (a) The recent sizable changes in exchange rates are not representative of underlying long-term trends. For example, the Korean FSA¹ argued:

The exchange rate fluctuations are expected to stabilize later on so the exchange rate for long-term foreign currency denominated assets and liabilities at the time of redemption or settlement becomes different from the rate at the current balance sheet date. However, the foreign exchange differences recognized in earnings without taking into account the maturity of the monetary items under current standards give rise to significant fluctuations in corporate earnings.

- (b) The IAS 21 approach creates a potential accounting mismatch. Consider the situation in which the entity's function currency is LC, but it generates significant RC cash flows. The cash flows will service the debt and the entity will avoid the reported gain or loss. In a sense, the entity has a natural hedge. The IAS 21 approach fails to distinguish this entity from one that has only LC cash inflows.

This is not a new observation. Paragraph 154 of FASB Statement No 52, *Foreign Currency Translation*, makes the following comment about the previous FASB standard:

Many respondents believe that the exchange risk exposure on foreign currency debt is effectively hedged in many cases by the foreign currency revenue potential of operating assets, but that this hedge is not recognized in the Statement 8 translation process. One result is large and frequent fluctuations in reported earnings, which many believe misrepresent the real performance of a company and

¹ Suggestions for IFRS Amendment Suitable for EMEs, received by the IASB in 2009.

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obscure operating trends. Another result is said to be erratic operating margins and irregular financial relationships that make operating performance difficult to interpret.

- (c) IAS 21 requires a spot rate to translate monetary liabilities, even if the payments are several years in the future. It should use forward rates instead. Constituents who raise this point maintain that long-dated forward rates are less volatile than spot rates.
8. Constituents have suggested a number of solutions, including:
- (a) Defer the accounting effects of translation and amortise the result over the remaining life of the translated asset or liability. This approach was recently enacted into legislation in India. Those who advocate deferral solutions observe that standard setters have adopted them in other situations, most notably pension accounting under IAS 19 and FAS 87.
 - (b) Recognise the accounting effects in OCI and recycle as in (a).

Observations

9. Many of the arguments against current recognition of exchange rate changes are based on the notion that rates “are expected to stabilize.” Standard setters have not found that argument persuasive in other situations. While exchange rate fluctuations may stabilise at some point, no one can predict when or if that will happen. More important, exchange rate markets may not, probably will not, return to the rates that existed when a particular loan was drawn. There is no way to know at the time whether a market movement is transitory or permanent.
10. The stronger argument is the accounting mismatch described in paragraph 7(b). The problem first described by the FASB persists in many situations under both the IASB and FASB standards. Eliminating that mismatch would be a useful avenue for research. However, many companies have foreign-currency denominated borrowings but do not have significant foreign-currency revenues.

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Topic 2 – The Functional Currency Model

11. Some constituents assert that the functional currency model in IAS 21 is the heart of the perceived problem. Some complain that it biases the accounting result against countries whose local currency is not a reserve currency.

Observation

12. The functional currency model is a device that allows accountants to distinguish transactions. Those that occur in the functional currency are not, by definition, foreign currency transactions. I find it hard to see how the model, per se, creates a bias. There must certainly be a market bias in favour of some currencies, but that bias creates real economic effects. The first of those is that there is an advantage, a lower interest rate, to be had by borrowing in RC rather than LC. The second is that the lower interest rate is purchased at the cost of increased foreign exchange risk.
13. Moreover, currency volatility is not limited to emerging markets. In the simple illustration at the beginning of this paper, the Canadian dollar and Pound Sterling showed losses similar to those of the Rupee, the Won, and the Rand.

Topic 3 – Convertible bonds denominated in a foreign currency

14. This is the first of several issues that involve the intersection between IAS 21 and some other standard. At its April 2005 meeting, the IFRIC decided that, “contracts that will be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency should be classified as liabilities.” As a consequence, the part of a convertible bond usually classified as equity is instead treated as a derivative instrument, with gains and losses reported in income.
15. At its June 2005 meeting, the IFRIC observed:

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The IFRIC decided to recommend that the Board consider amending IAS 32 so that, for classification purposes only, a fixed amount of foreign currency is considered to be a fixed amount of cash. The IFRIC noted that such an amendment would result in such instruments being classified as equity under IAS 32.

16. The Board considered the IFRIC's request at its September 2005 meeting.

Update for that meeting reports:

At this meeting the Board noted that the proposed amendment would result in equity and foreign exchange features whose values are interdependent being recognised in equity. The Board observed that excluding from equity the value attributable to the foreign exchange features would require arbitrary rules. The Board also noted that allowing dual indexed contracts (to share price and foreign exchange rates) to be classified as equity would require additional and detailed guidance to avoid structuring opportunities aimed at obtaining a desired accounting result. The Board decided not to proceed with an amendment.

17. Many have disagreed with the IFRIC and Board decisions, maintaining that the solution described in paragraph 15 is not a necessary extension of the "fixed for fixed" rule in IAS 32. They maintain that an exchange is still fixed, even if it is denominated in something other than the entity's presentation currency. They also observe that the Board recently addressed another situation in its amendment to IAS 32, *Classification of Rights Issues*. They point to Jim Leisenring's dissent, which reads in part:

Mr Leisenring would have preferred to conclude that a right granted for a fixed amount of a currency was a 'fixed for fixed' exchange rather than create additional conditions to the determination of a liability.

Topic 4 – Other comprehensive income

18. Paragraph 32 of IAS 21 provides:

Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation (see paragraph 15) shall be recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate. In the financial statements that include the foreign operation and the reporting entity

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(eg consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in a separate component of equity and recognised in profit or loss on disposal of the net investment in accordance with paragraph 48.

19. For these purposes, the key word here is “disposal.” That is the only way in which the amount can be removed from accumulated other comprehensive income. The foreign operation may be distribute a significant portion of its assets through dividends, but the amount remains in accumulated other comprehensive income, even if it exceeds the assets in the foreign operation. A detailed illustration is attached as an appendix.

Topic 5 – Foreign currency hedge accounting

20. The document prepared by the Korean FSA (see note 1) describes this topic as follows:

(1) Background

Under IAS39, when applying fair value hedge accounting for a firm commitment, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognized as an asset or liability and the fair value of the hedging instrument is recognized as an asset or liability bilaterally. In addition, the firm commitment and the hedging instrument do not offset each other in the balance sheet and recorded at the gross amount respectively. Consequently, when hedging the foreign currency risk of a firm commitment, huge amounts of financial assets and liabilities are recorded as the foreign exchange rate fluctuates.

(2) Issue

When a ship building company enters into a long-term foreign currency contract, the company usually enters into a corresponding currency forward contract to hedge the foreign currency risk as well. On the other hand, the remaining balance of orders and the forward contracts of major ship building companies reach twice their annual sales as they hold the amount of orders for more than 3 years hereafter.

In this case, while a company's foreign currency risk is mostly hedged so that the changes in foreign exchange rate do not affect the company's worth, huge amounts of firm commitment assets and

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currency forward liabilities took up to 30% of the company's total assets due to the recent soaring foreign exchange rate resulting in the company's financial position looking more at risk than in actuality. In addition, the excessive fluctuations of the overall financial ratios such as ROA and debt ratio resulting from the changes of foreign exchange rates, irrelevant to the company's operations, interfere with financial statement users' appropriate decision on the company's financial position and its prospects.

21. The document recommends net or linked presentation of the firm commitment and the hedging instrument. The IASB staff intends to raise this issue with the Board as part of its reconsideration of hedge accounting under IAS 39.

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Appendix

22. The example is drawn from KPMG's *Insights into IFRS, 3rd edition* and expanded.

Base Case

23. Consider a parent that owns 100% of the stock in a single subsidiary. The stock was acquired on January 1, X5. For simplicity, assume the price was equal to the carrying amount of the net assets. The subsidiary's function currency is the BC. The parent's functional currency is the AC, and the presentation currency for the group statements is the AC. BC-AC exchange rates have been as follows:

	BC	AC
Exchange rate at January 1 X5	1	1
Average rate during X5	1	1.25
Exchange rate at December 31 X5	1	1.5
Average rate during X6	1	2
Exchange rate at December 31 X6	1	2.5

24. The subsidiary's balance sheet at December 31, X6, including translation, is:

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Subsidiary balance sheet, December 31 X6	BC	rate	AC
Other assets and liabilities	2,000	2.5	5,000
PP&E	2,800	2.5	7,000
Paid in capital	(400)	1	(400)
Retained earnings at acquisition	(2,200)	1	(2,200)
2005 Retained earnings layer	(900)	1.25	(1,125)
2006 profit	(1,300)	2	(2,600)
Foreign currency adjustment	-		(5,675)
footing	-		-

25. KPMG offers the following reconciliation of the foreign currency adjustment.

Proof of Translation adjustment	Actual	Closing	difference	in BC	in AC
Share capital	1	2.5	1.5	(400)	(600)
Retained earnings at acquisition	1	2.5	1.5	(2,200)	(3,300)
2005 Retained earnings layer	1.25	2.5	1.25	(900)	(1,125)
2006 profit	2	2.5	0.5	(1,300)	(650)
					(5,675)

26. The consolidation worksheet, including a portion of the parent's assets and liabilities related to its investment in the subsidiary, is:

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Consolidation worksheet				
	Subsidiary	Parent	Eliminations	Consolidated
Other assets and liabilities	5,000	(2,600)		2,400
Investment in subsidiary		2,600	(2,600)	-
PP&E	7,000			7,000
Paid in capital	(400)		400	-
Retained earnings at acquisition	(2,200)		2,200	-
2005 Retained earnings layer	(1,125)			(1,125)
2006 profit	(2,600)			(2,600)
Foreign currency adjustment	(5,675)			(5,675)
footing	-	-	-	-

Variation 1, Small Dividend

27. Now, assume that the subsidiary paid a dividend of BC 600 during X6. At the time, the conversion rate was 2.25. Now, the subsidiary's balance sheet would be:

Subsidiary balance sheet, December 31 X6	BC	rate	AC
Other assets and liabilities	1,400	2.5	3,500
PP&E	2,800	2.5	7,000
Paid in capital	(400)	1	(400)
Retained earnings at acquisition	(2,200)	1	(2,200)
2005 Retained earnings layer	(900)	1.25	(1,125)
Dividend paid	600	2.25	1,350
2006 profit	(1,300)		(2,600)
Foreign currency adjustment	-		(5,525)
footing	-		-

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28. Items that change from the base case because of the dividend payment are shaded. The consolidation worksheet would be as below, again with shading:

Consolidation worksheet				
	Subsidiary	Parent	Eliminations	Consolidated
Other assets and liabilities	3,500	(1,250)		2,250
Investment in subsidiary		2,600	(2,600)	-
PP&E	7,000			7,000
Paid in capital	(400)		400	-
Retained earnings at acquisition	(2,200)		2,200	-
2005 Retained earnings layer	(1,125)			(1,125)
Dividend paid	1,350		(1,350)	
2006 profit	(2,600)	(1,350)	1,350	(2,600)
Foreign currency adjustment	(5,525)			(5,525)
footing	-	-	-	-

29. So far, the example is fairly straightforward and not very interesting, except that the foreign currency adjustment is now the majority of the subsidiary's equity (5,525 compared to 4,575).

Variation 2, Large Dividend

30. Now assume that during X6 the subsidiary sold half of its PP&E for the carrying amount, realizing BC 1,400. It then pays a dividend to the parent of BC 3,000 when the exchange rate is 2.25. The parent receives AC 6,750. The subsidiary balance sheet looks like this.

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Subsidiary balance sheet, December 31 X6	BC	rate	AC
Other assets and liabilities	400	2.5	1,000
PP&E	1,400	2.5	3,500
Paid in capital	(400)	1	(400)
Retained earnings at acquisition	(2,200)	1	(2,200)
2005 Retained earnings layer	(900)	1.25	(1,125)
Dividend paid	3,000	2.25	6,750
2006 profit	(1,300)	2	(2,600)
Foreign currency adjustment	-		(4,925)
footing	-		-

31. And the consolidation looks like this:

Consolidation worksheet				
	Subsidiary	Parent	Eliminations	Consolidated
Other assets and liabilities	1,000	4,150		5,150
Investment in subsidiary		2,600	(2,600)	-
PP&E	3,500			3,500
Paid in capital	(400)		400	-
Retained earnings at acquisition	(2,200)		2,200	-
2005 Retained earnings layer	(1,125)			(1,125)
Dividend paid	6,750		(6,750)	
2006 profit	(2,600)	(6,750)	6,750	(2,600)
Foreign currency adjustment	(4,925)			(4,925)
footing	-	-	-	-

32. Note that the foreign currency translation adjustment, BC (4,925), now exceeds the net assets of the foreign subsidiary, BC 4,500.