Appendix – A Research Report on Foreign Currency Accounting

Foreign Currency Accounting Issues

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Korea Accounting Standards Board

Summary

I. Introduction

Background

S1. With the globalization of capital flows, the foreign exchange market's volatility has been increasing. As the world went through the 1997 Asian financial crisis and the recent global financial crisis of 2008, entities in countries or jurisdictions that are affected by the significant changes in exchange rates raised concerns that the current accounting standards related to foreign currency translation might not reflect the true economic substance. Thus it was suggested that a comprehensive review of foreign currency accounting needs to be conducted in order to address such concerns.

S2. We agreed that it is appropriate to perform a review of IAS 21 in order to address such an issue. The reason behind this conclusion was because it was difficult to understand clearly the conceptual basis for the current translation requirement in IAS 21. For example, due to the lack of objective of foreign currency translation, it is difficult to understand what kind of information is supposed to be provided via the prescribed translation methods.

S3. That is why we thought that a comprehensive review of IAS 21 is needed in order to make the translation objective and methods clearer from a conceptual point of view.

S4. The comprehensive review would also provide a foundation for determining whether potential alternatives to be discussed in detail are appropriate.

Objective

S5. This report is prepared with an objective to provide **a foundation for carrying out the**

basic research into a comprehensive review of IAS 21. This report is also prepared as a reference material to ask the IASB to officially **include foreign currency accounting in their post-2011 agenda**.

Scope

S6. **This report focuses more on the topic of "translation of foreign currency transactions"** [1] than the topic of "translation of functional currency financial statements"[2] since most of the issues directly raised by stakeholders were related to the former topic.

II. Objective of Foreign Currency Translation

Background

S7. Since the objective of foreign currency translation is not specifically described in IAS 21, it is difficult to understand what kind of information is supposed to be provided via foreign currency accounting.

Findings

S8. In order to understand the objective of foreign currency translation implied in IAS 21, the objective of foreign currency translation in SFAS 52 (US GAAP) was referred to, and we supposed that the objective of foreign currency translation in SFAS 52 is closely related to the concepts of foreign currency risk and economic exposure.

Suggestions

S9. We deemed it necessary to discuss the following issues when determining the objective

[1] 'translation of foreign currency transactions' indicates ' reporting at the ends of subsequent reporting periods', the paragraph 23 of IAS 21
[2] 'translation of functional currency statements' indicates 'translation to the presentation currency' , the paragraph 39 of IAS 21

of foreign currency translation in IAS 21.

- Clear and accurate definition of foreign currency risk:
  In current IFRS 7, the definition of foreign currency risk is described as pertinent only to financial instruments. However, there should be clear definitions of terms because foreign currency risk is not mentioned in IAS 21 and if the definition in IFRS 7 is applied to IAS 21, non-financial instruments would be interpreted as carrying no foreign currency risk.

- Consideration of limits to accounting exposure:
  One should consider that economic exposure may not always be properly reflected in the financial statements.

- Separate definitions for the objective of “translation of foreign currency transactions” and the objective of “translation of functional currency financial statements”:
  Accounting treatments for translation of foreign currency transactions and for translation of functional currency financial statements differ from each other, and consequently, the objectives of the two aforementioned translations ought to be different from each other.

III. Relationship between Foreign Currency Translation and Measurement

Background

S10. IAS 21 lacks conceptual discussions on measurement basis for foreign currency translation methods.

Findings and Issues

S11. Translation in IAS 21 may be conceptually defined from one of the following two viewpoints:

(a) Viewpoint of the temporal method[3]

(b) Viewpoint of fair value measurement

S12. From the viewpoint of the temporal method, translation is viewed more as an inevitable accounting procedure that must be executed to state amounts in one currency rather than measuring foreign currency risk. Therefore, using the economic exposure concept in determining the objective of foreign currency translation would be inconsistent with this view.

S13. **The first issue** that arises in the viewpoint of fair value is that **the applicable principle for nonmonetary items and the applicable principle for monetary items would differ from each other**.

- Monetary item: The principle applied to monetary items views reflecting some changes in fair value as useful. In other words, it assumes that, even though an item itself is not measured at fair value in entirety, recognition of a change in exchange rate, i.e. a part of total fair value changes, provides more useful information.

- Nonmonetary item: The principle applied to nonmonetary items views it inappropriate to reflect only some fair value changes. In other words, it assumes that if an item is not measured at fair value, recognition of a change in exchange rate, i.e. only a part of fair value changes, does not provide useful information.

S14. **The second issue** that arises in the viewpoint of fair value is about **accounting treatment when the market exchange rate is unable to reflect fair value.**

- According to IFRS 13, the fair value measurement standard, when the market price is unable to represent fair value under exceptional circumstances, the fair value is generally calculated using valuation techniques.
- When the volume or level of activity in the market has significantly decreased, it may indicate that the market price does not represent fair value.

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3 Refer to paragraph 3.9-3.10 for description of 'temporal method'

- IFRS 13 may be applied to the exchange rate market when liquidity significantly decreases due to intensified fluctuations in exchange rates.
- In IAS 21, however, there is no consideration given to this issue.

S15. We also observed that IAS 21, specifying only the translation methods for items measured at historical cost and at fair value, lacks explicit requirements for nonmonetary items measured by other measurement basis (e.g., provisions in compliance with IAS 37).

Suggestions

S16. **From the temporal method point of view**, further discussions are needed on **the appropriateness of translating monetary items measured at amortised cost using the current exchange rate**.

S17. **From the viewpoint of fair value measurement**, we suggest the following:

- **To resolve the problem of different principles applied to nonmonetary items and monetary items, (a) or (b) as below can be considered:**
  (a) Eliminating requirements related to nonmonetary items in IAS 21, or
  (b) Translating all items at current rates without the distinction between monetary and nonmonetary items.

- When market exchange rates do not reflect fair values under exceptional circumstances, it would be more appropriate to specify in IAS 21 cases where the market rates are unable to reflect fair values under exceptional circumstances and alternative accounting treatments accordingly.

S18. Translation requirements about nonmonetary items measured at a measurement basis other than historical cost or fair value should be clearly stated in IAS 21.

IV. Distinguishing Monetary and Nonmonetary Items

Background

S19. Questions arise about the theoretical basis of the translation method required in IAS 21, which is based on the monetary/nonmonetary distinction. Also, there are also cases in which the distinction between monetary and nonmonetary items is ambiguous.

Findings

S20. The monetary/nonmonetary method was used since 1950s but SFAS 8 adopted the temporal method instead of monetary/nonmonetary method. However, although SFAS 52 did not adopt the monetary/nonmonetary method, the concept was reused.

Suggestions

S21. We suggest clarifying the theoretical basis for using the monetary/nonmonetary concept, and seeking alternatives to the monetary/nonmonetary distinction.

- Clarification of theoretical basis for using the monetary/nonmonetary concept:
  It was possible to explain the monetary/nonmonetary method used in the past with theories like the purchasing power parity because none of the nonmonetary items are translated according to the method.[4] However, under the current foreign currency translation method, such theories cannot provide a basis because those nonmonetary items measured at fair value are translated, rather than not translating nonmonetary items as a whole.

- Consideration to be given to alternatives to the monetary/nonmonetary distinction:
  There are cases in which the distinction between monetary and nonmonetary items is ambiguous when an item has both monetary and nonmonetary characteristics (e.g., foreign currency denominated available for sale debt

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[4] Under the assumption that the purchasing power parity holds, a change in foreign exchange rate is exactly offset by a change in price of the foreign currency of an item, which justifies non-translation for that item. For example, when foreign exchange rate decreases by 10%, the price of the foreign currency of a nonmonetary item increases by 10%, offsetting foreign exchange loss, and consequently it is unnecessary to translate the nonmonetary item.

instrument).

V. Definition of Functional Currency

Background

S22. The definition of a foreign operation is interpreted in a restrictive manner in IAS 21. A foreign operation is defined in IAS 21 as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity. Therefore it may be interpreted as that those other than the legal entities specified in the definition may not be defined as foreign operations.

Findings

S23. Based on the definition of a reporting entity in "Exposure Draft: Conceptual Framework for Financial Reporting – The Reporting Entity,"[5] published by the IASB and the statement in SFAS 52 that "in some instances, a foreign entity might have more than one distinct and separable operation,"[6] we noted that there is no reason to limit a foreign operation to those prescribed in IAS 21.

Suggestions

S24. The definition of a foreign operation needs to be amended so that the functional currency can be determined according to the economic substance.

VI. Recognition of Foreign Exchange Gains or Losses

Background

S25. IAS 21 does not clearly point out what the objective of translation is and thus it is

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[5] Refer to "Exposure Draft: Conceptual Framework for Financial Reporting – The Reporting Entity" by IASB, March 2010

[6] Paragraph 43 of SFAS 52

impossible to determine how the resulting foreign exchange gains and losses should be recognised in order to conform to the objective.

Findings

S26. IAS 21 requires foreign exchange gains and losses to be recognised in profit or loss for the period resulting from translation of foreign currency transactions involving monetary items. Judging from this requirement, IAS 21 seems to view a change in exchange rates as a separate event that occurred to a reporting entity and thus regard that it is appropriate to recognise the foreign exchange gains and losses in profit or loss, i.e., as realised gains and losses, since the effect of a rate change has direct cash flow effects on the monetary item.

S27. However, there are cases where a rate change has a high possibility of reversal, that is, a low possibility of realisation into cash flows and thus it is not appropriate to recognise foreign exchange gains or losses of all monetary items as realised gains or losses.

Suggestions

S28. We believe there is a **need to examine whether foreign exchange gains or losses should be recognised in profit or loss or in other comprehensive income based on the distinction between current items and non-current items**. We believe so because this approach is consistent with accrual basis accounting, that is, the effects of rate changes having cash flow effects are recognised in the same period in which the causative event occurred. Furthermore, fluctuation of profit or loss account would be reduced by recognising foreign exchange gains or losses of non-current items which have a high possibility of reversal of such gains or losses. However, additional reviews should be conducted to determine if and when foreign exchange gains or losses of non-current items recognised in other comprehensive income should be recycled.

S29. **An alternative that recognises foreign exchange gains or losses of all monetary items in other comprehensive income may be considered.** Although this method may be able to reduce complexity caused by recycling as well as profit or loss fluctuation caused by translation, in the absence of any conceptual definition for other comprehensive income, this method recognises foreign exchange gains or losses of short-term trading items in other comprehensive income even though the items have a high likelihood of immediate realisation. Therefore, conceptual examination of other comprehensive income should precede.

VII. Linked Presentation

Background

S30. Hedge accounting has been introduced because general accounting treatments cannot present hedging activities of a reporting entity. The objective of hedge accounting is to reflect in the financial statements and thus help users of the financial statements to understand how the management of an entity deals with the risks the entity faces as well as the resulting financial consequences.

S31. However, presenting hedged items and hedging instruments in gross amounts would mislead the users of financial statements because the gross presentation of hedging activities of the reporting entity would not be in accordance with the economic substance.

Findings

S32. Linked presentation shows exactly the same information as “unlinked” presentation. Furthermore, linked presentation even provides additional information showing that certain assets and liabilities are significantly related. Also, linked presentation explains the fact that derivatives are used for the purpose of hedging activities.

Suggestions

S33. It is true that the current gross presentation method has many advantages. However, we believe that there is a need to examine linked presentation for fair value hedge accounting in order to more appropriately present hedge accounting and provide useful information to the users of financial statements.

VIII. Miscellaneous

S34. The following issues may be discussed further:

- Convergence between IFRSs and U.S. GAAP
- Consistency across IFRSs
- Review of Alternative Exchange Rates
- Practical issues raised by the Working Group
- Other Practical Issues

S35. Items that require convergence between IFRSs and U.S. GAAP are as follows:

Items	IFRSs	U.S. GAAP
Exchange difference of available for sale debt instruments	Effects of rate changes are recognised in profit or loss for the period.	Effects of rate changes are recognised in other comprehensive income
Accounting treatment in hyperinflationary economies	Restate financial statements in terms of the general level of prices when translating into presentation currency.	Financial statements of an entity are remeasured as if the functional currency were the reporting currency.

S36. The following should be reviewed in order to enhance consistency across IFRSs:

- The difference between the definition of foreign currency risk in IFRS 7 and that implied in IAS 39.
- The basis for recognising exchange differences of monetary items in standards other than IAS 21 (e.g., in 'Borrowing Costs' in IAS 23, exchange differences are not immediately recognised in profit or loss for the period, but this is not referred to as an exception in IAS 21).

S37. In the review of alternative exchange rates, an ex post empirical analysis showed that, when exchange rates fluctuate rapidly, applying a moving average exchange rate instead of a nominal exchange rate as of the balance sheet date better reflected the economic substance. Therefore, further discussions are needed on the appropriateness or practical applicability of such exchange rate.

S38. Practical issues raised by the Working Group are as follows:

- Guidelines are needed for determining average exchange rate when an average exchange rate is used instead of the exchange rate at the transaction date (e.g., a general methodology, periods for average exchange rates, etc.).
- For translation of foreign currency transactions, there are accounting treatments specified for using a number of different exchange rates or cases where exchange between two currencies is temporarily unavailable. However, there is no such accounting treatment specified for translation of functional currency financial statements, and thus related guidelines should be provided.

S39. Other practical issues include the following:

- For advance receipt denominated in foreign currency, there is an issue of whether sales amount should be recognised using the exchange rate at the time of recognising the sale or the exchange rate at the time of recognising the advance receipt since unearned revenue is a nonmonetary item.

Contents

I. Introduction

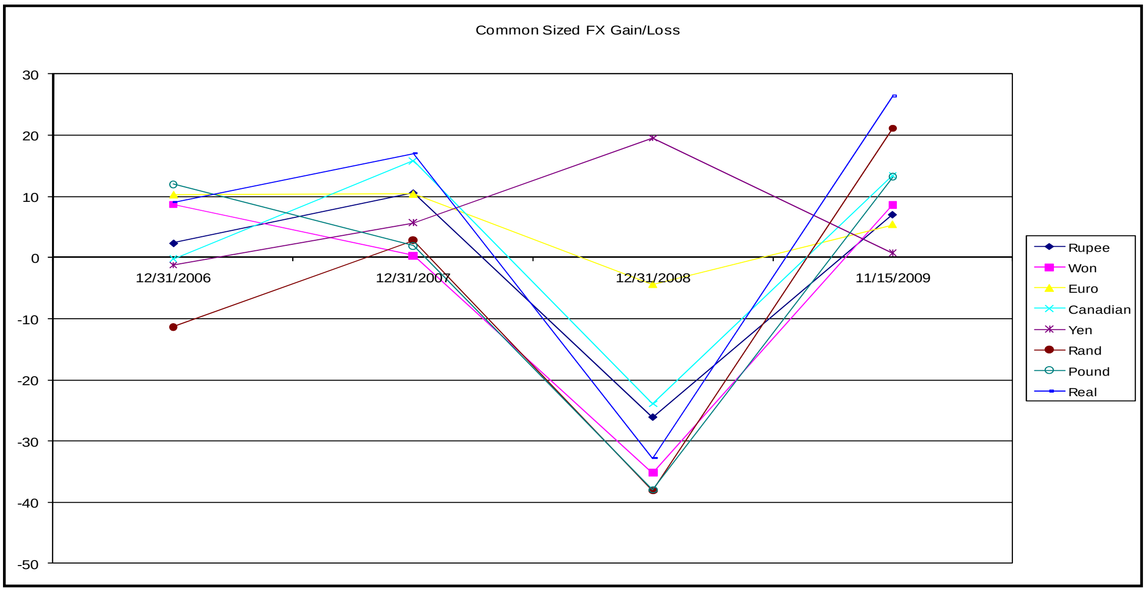
<u>Background</u>

Entities Raising Issues in times of Global Economic Crises

1.1 The foreign exchange market's movement is affected by a variety of factors, with numerous stakeholders participating in the market. For jurisdictions or countries that have adopted a floating exchange rate system, their foreign exchange rates are inevitably exposed to greater volatility due to the complicated effects of the different factors influencing the market. In particular, the volatility of the foreign exchange market is growing even greater as the barriers to international flows of capital are further diminished. The increased volatility of the foreign exchange market is often further amplified in times of global economic crises, causing entities to face unexpected problems.

1.2 The volatility of the foreign exchange market was increased during the recent global financial crisis of 2008. This was an international phenomenon. Graph 1 below shows foreign exchange gains or losses of different currencies, comparing the exchange rate of each currency at the end of each year against the US dollar. The graph shows that the volatility of most currencies was intensified as of the end of 2008.

<Graph 1: Foreign Exchange Profits or Losses of Different Currencies>



1.3 Entities in countries or jurisdictions that do not use a reserve currency and actively engage in foreign currency transactions like Korea have complained of difficulties caused by the significant fluctuation of the foreign exchange market. They also **argued that there is a need to amend the accounting standards associated with foreign currency accounting**. For instance, they argued that the current accounting standards related to foreign currency translation might not reflect the true economic substance of long-term assets and liabilities denominated in foreign currency because, despite the fact that their term of redemption is long-term, foreign exchange rates in the corresponding reporting periods are used, even when the rate is abnormally high or low, to translate the amounts that are to be repaid in the future and the resulting foreign exchange gains or losses are recognised in profit or loss in the period in which they arise. A global economic crisis similar to the current crisis had already happened before in 1997, and entities then raised similar issues regarding foreign currency accounting.

Need for Comprehensive Review of Foreign Currency Accounting

1.4 An increasing number of stakeholders are calling for a comprehensive review of foreign currency accounting to address the entities' demands. Such review is necessary because, without a system that can strengthen stability of the global capital market, global economic crises may occur periodically in the future and thus the questions as to foreign currency accounting would continue to be repeated. On the other hand, some consider the issues raised by the entities merely as a matter of foreign exchange market operation rather a matter of foreign currency accounting requirement. In fact, they believe that the current foreign currency accounting clearly shows the economic substance of entities and thus view the deteriorated financial statements during an economic crisis as a natural consequence.

1.5 We have considered the two conflicting views and **come to think that it is more appropriate to perform a review of foreign currency accounting**. The reason behind this conclusion was because it was difficult to understand conceptually the basis for the current translation requirement in IAS 21 *The Effects of Changes in Foreign Exchange Rates,* in particular, the requirement for "Reporting at the ends of subsequent reporting periods" as stated in paragraph 23. We found that IAS 21 provides insufficient background information as to why the translation method in paragraph 23 was selected over other possible alternatives. We also thought that objective of foreign currency translation, which is not explicitly set out in IAS 21, should be included in IAS 21 because a particular translation method can only be justified by meeting the objective of foreign currency translation in the first place. Thus it is necessary to review IAS 21 comprehensively in order to address the topic of 'objective of foreign currency translation'.

Importance of Comprehensive Review of Foreign Currency Accounting

1.6 Conceptual clarification of the translation requirements in IAS 21 will be useful in reviewing the relevance of possible alternatives in the future. For instance, to examine whether it is more appropriate to recognise a gain or loss on a monetary item from changes in foreign exchange rates in other comprehensive income instead of profit or loss in the period in which they arise, defining the objective of translation and considering the relevance in accordance with the objective would be helpful. For another instance, a clearly defined objective of translation would be useful in determining the relevance when examining whether it is more appropriate to present assets and liabilities generated as a result of currency risk hedge accounting, i.e., firm commitments and derivatives, using the current gross presentation method or the linked presentation method suggested by some entities.

Progress of Basic Research

1.7 Korea began basic research for improving foreign currency accounting by organizing an international Working Group (WG) in 2010 with other countries sharing the need for the basic research, following the advice of Wayne Upton, IASB Director of International Activities. . The WG consisting of Australia, Brazil, Canada, India, Korea, and South Africa shared their views through three official meetings.

Objective

1.8 This report is prepared with an objective to provide **a foundation for carrying out the basic research into a comprehensive review of IAS 21**. In other words, this report does not contain the entire result of the basic research on the comprehensive review of IAS 21, but goes over issues that should be addressed when conducting the basic research. This report, however, does not exclude proposition of possible alternatives that may be considered.

1.9 This report is also prepared as a reference material to ask the IASB to include foreign currency accounting in their post-2011 agenda so that the WG on foreign currency accounting could continue its in-depth basic research on the subject.

Scope and Structure

1.10 The translation requirement of IAS 21 is divided into (1) Reporting foreign currency transactions in the functional currency and (2) Translating to the presentation currency other than the functional currency. Reporting foreign currency transactions in the functional currency may then be divided into “initial recognition” and “measurement at the ends of subsequent reporting periods.” For convenience’ sake, however, we would like to hereinafter refer to “translation of foreign currency transactions” to represent “measurement at the ends of subsequent reporting periods when reporting foreign currency transactions in the functional currency,” and refer to “translation of functional currency financial statements” to represent “translating to the presentation currency other than the functional currency.” (see Table 1 as below)

<Table 1: Terminology>

Terms in this Report	What they mean in IAS 21
Translation of foreign currency transactions	Measurement at the ends of subsequent reporting periods when reporting foreign currency transactions in the functional currency
Translation of functional currency financial statements	Translating to the presentation currency other than the functional currency

1.11 Although the issues related to “translation of functional currency financial statements” should also be examined in their entirety in order to comprehensively review IAS 21, we decided to focus on the topic of “translation of foreign currency transactions” since most of the issues directly raised by stakeholders were related to this specific topic. However, we have not completely excluded the issue of "translation of functional currency financial statements" because there is some common ground between the two topics.

1.12 Below are the key topics discussed in this report to improve IAS 21:

- Objective of foreign currency translation,
- Relationship between foreign currency translation and measurement,
- Distinguishing monetary and nonmonetary items,
- Definition of functional currency,
- Recognition of foreign exchange gains or losses,
- Linked presentation, and
- Miscellaneous.

II. Objective of Foreign Currency Translation

Background

2.1 We considered which topic should be the first one to be discussed in order to specify accounting for foreign currency translation. Although there are many possible answers to this question, we believe that the most fundamental topic is to understand what the objective of foreign currency translation is.

2.2 This decision would be deemed appropriate, for the IASB's or FASB's standards for foreign currency translation are structured in a similar manner. In IAS 21, the objective of the standard is specified in the first paragraph. Also in SFAS 52 (Accounting Standard Codification 830-10-10-2)[7], which is a U.S. GAAP standard, the objective of translation is described at the very first.

IAS 21 without the Objective of Foreign Currency Translation

2.3 While we were examining the objective paragraph in IAS 21, we discovered that the paragraph did not provide an objective of foreign currency translation. In other words, the paragraph did not state what kind of information is to be provided through the accounting for foreign currency translation. Instead, the paragraph simply states that the objective of the standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements and also how to translate financial statements into a presentation currency.

Detailed Paragraph on the Objective of Foreign Currency Translation in SFAS 52

2.4 In SFAS 52, not only is the objective of foreign currency translation clearly set out, but also the basis for conclusion describes what has been reviewed in detail including many alternatives. The basis for conclusion in IAS 21 also includes discussions about

[7] While SFAS 52 was repealed and replaced by Accounting Standard Codification, the content of the standard is still maintained, and thus, for convenience' sake, the current U.S. GAAP standard on foreign currency translation is referred to as SFAS 52 in this report.

translation of financial statements, and thus one may indirectly guess the objective regarding the method for translating financial statements. However, there is no discussion about translation of foreign currency transactions, which is the main topic of this report, in IAS 21 other than the discussion on capitalization of exchange differences in paragraphs BC24 and BC25. Therefore, unlike SFAS 52, it is difficult to understand what the objective of accounting for translation of foreign currency transactions is in IAS 21.

2.5 Consequently, we reviewed the said topic in this report in order to find answers to the following issues:

- Point 1: Is the objective of foreign currency translation in IAS 21 the same as that of SFAS 52?
- Point 2: What is the meaning of the objective of foreign currency translation in SFAS 52?
- Point 3: What should be considered when the objective paragraph in IAS 21 is to be improved?

Issues

Point 1: Is the objective of foreign currency translation in IAS 21 the same as that of SFAS 52?

2.6 In order to understand the objective of foreign currency translation in current IAS 21, accounting standards of other countries may be used as reference. In this report, we have examined SFAS 52 to find out if this standard may be referred to in understanding IAS 21. If the objective of foreign currency translation stated in SFAS 52 is the same as that of current IAS 21, then we would be able to obtain certain suggestions as to how to specify the objective of foreign currency translation when trying to improve IAS 21 by examining the objective of foreign currency translation in SFAS 52. In other words, if the objective of foreign currency translation is clearly and accurately stated in SFAS 52, the same objective may also be used for IAS 21. If the objective of foreign currency translation in SFAS 52 needs improvement, then IAS 21 may be amended by reflecting such improvement.

2.7 Now we need to know if the objectives of foreign currency translation in IAS 21 and SFAS 52 truly are the same. We have studied the relationship between IAS 21 and SFAS 52 as of when they were first issued, and we have reached a conclusion that these two standards are substantially the same. The following is the basis for our conclusion.

2.8 IAS 21 was first issued in 1983, two years after the issuance of SFAS 52 in 1981. However, note that in 1983, not only IAS 21, but also SSAP#20 and Section #1650, standards for foreign currency translation for the U.K. and Canada, were issued.[8] The timing of the issuance of these standards was not a coincidence. This was the result of joint discussions from 1979 to 1982 among the IASC (currently the IASB), the U.S., the U.K, and Canada in an effort to bring about harmonization of foreign currency translation requirements.[9]

2.9 The paragraphs on the objective of foreign currency translation in the standards of the U.K and Canada are quite similar to that of SFAS 52. The content of paragraph 4 of SFAS 52 is almost entirely included in SSAP#20 with the sentence "The translation of foreign currency transactions and financial statements should present a true and fair view of the results of management actions" added to the objective.[10] Furthermore, Section #1650 of Canada included the content of paragraph 4 of SFAS 52 in its objective paragraph when it was amended in 1996.[11] Therefore, we can infer that the objective of foreign currency translation in the old IAS 21 issued at the same time as these standards is similar to that of SFAS 52.

2.10 Moreover, SSAP#20 issued in 1983 states that compliance with SSAP#20 is recognised as compliance with IAS 21.[12] This proves that **the objective of foreign currency translation in the old IAS 21 is similar to that of SFAS 52**.

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[8] Kazumoto Ido, "Historical Changes of Accounting for Translation of Foreign Currency Financial Statements", 名古屋外国語大学現代国際学部　紀要　第5号(March 2009). p.141

[9] The Canadian Institute of Chartered Accountants, "Research Report: Foreign Currency Translation Issues", May 1989. p.71 and FASB, "Statement of Financial Accounting Standards No. 52: Foreign Currency Translation", 1981. Para. 76

[10] The Institute of Chartered Accountants in England & Wales, "Statement of Standard Accounting Practice No 20: Foreign Currency Translation", 1983. Para. 2

[11] The Canadian Institute of Chartered Accountants, "Re-Exposure Draft: Foreign Currency Translation", May 1996. Para. .049

[12] The Institute of Chartered Accountants in England & Wales, "Statement of Standard Accounting Practice No 20: Foreign Currency Translation", 1983. Para. 72

2.11 Thus, examining the objective of foreign currency translation specified in SFAS 52 will help determine the objective of foreign currency translation in IAS 21.

Point 2: What is the meaning of the objective of foreign currency translation in SFAS 52?

2.12 Paragraph 4 of SFAS 52 sets out the objective of foreign currency translation as follows:

> (…) Accordingly, the translation of the financial statements of each component entity of an enterprise should accomplish the following objectives:
>
> a. Provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity
>
> b. Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. generally accepted accounting principles

2.13 The above paragraphs, however, state only the objective of translation of functional currency financial statements, but not the objective of translation of foreign currency transactions. Furthermore, the objective of translation of foreign currency transactions is not clearly stated in other paragraphs either, including the basis for conclusion paragraph.

2.14 We believe, however, that paragraph 71 of SFAS 52, which is the basis for conclusion paragraph concerning the above-mentioned paragraph 4, may provide the grounds on which the same objective as that of translation of functional currency financial statements may be applied to translation of foreign currency transactions. Paragraph 71, while explaining “the compatibility with the expected economic effects of a rate change on an enterprise's cash flows” mentioned in paragraph 4, states that “compatibility in terms of cash flow consequences is achieved if rate changes that are reasonably expected to impact either functional or reporting currency cash flows are reflected as gains or losses in determining net income for the period.” That is, the cash flows of functional currency would be affected not only by translation of foreign currency financial statements but also by translation of foreign currency transactions. Hereinafter, this report proceeds on the assumption that the objective of SFAS 52 includes the objective of translation of foreign currency transactions.

> 71. Objective (a), to provide information that is generally compatible with the expected economic effects of a rate change, was adopted by the Board as the basic objective. This was responsive to the pervasive criticism that translation results under Statement 8 do not reflect the underlying reality of foreign operations. The Board focused on two aspects of accounting results and their compatibility with the economic effects of a rate change—changes in equity and cash flow consequences. Compatibility in terms of effect on equity is achieved, for example, if an exchange rate change that is favorable to an enterprise's exposed position produces an accounting result that increases equity. Compatibility in terms of cash flow consequences is achieved if rate changes that are reasonably expected to impact either functional or reporting currency cash flows are reflected as gains or losses in determining net income for the period, and the effect of rate changes that have only remote and uncertain implications for realisation are excluded from determining net income for the period.

2.15 We studied in detail what the “economic effect of a rate change” mentioned in paragraph 4a in SFAS 52, specifically means. Paragraph 67 in SFAS 52 may be referred to in regard to this, since the paragraph implies that the information that best describes the economic effect of exchange rate changes are those that clearly indicate **currency exposure** to **foreign exchange risk.**

> The problem is complicated by the fact that foreign operations differ greatly in structure and substance. In some situations, only certain assets and liabilities are exposed to foreign exchange risk, whereas in others the entire foreign operation or net investment is exposed to foreign exchange risk. These differences can significantly change the economic effect of exchange rate fluctuations.

2.16 Thus, we examined below the meanings of foreign currency risk and currency exposure to better understand the objective of foreign currency translation in SFAS 52.

Meanings of Foreign Currency Risk and Currency Exposure

2.17 The relationship between foreign currency risk and currency exposure may be referred to the definition by Adler & Dumas (1984)[13], which may be seen as the first research to be conducted on currency exposure in the field of economics. In their research paper, definitions of foreign currency risk and currency exposure are distinguished from each other. Foreign currency risk is defined as a statistic that shows the probability of the real purchasing power of a domestic currency or foreign currency at a certain point in time in the future, changing from the initially expected value. On the other hand, currency exposure is defined by determining what faces risks.

2.18 For instance, let us assume that: there are only two currencies of dollar and French franc; all investors in the U.S. are identical to each other; and there is no dollar inflation and no foreign currency risk for the domestic currency. Also, inflation of franc and movement of foreign exchange rates are expected to be random. Furthermore, the investors in the U.S. are to receive FF 1,000 three months later, with certainty. Here, one could instinctively understand that the amount exposed to foreign currency risk is FF 1,000. It is because FF 1,000 precisely shows the sensitivity of the future value of franc in dollars regarding exchange rate fluctuations. However, if the future value of franc is uncertain, the amount exposed to foreign currency risk will become even greater. This is so because the volatility of franc is increased, thereby increasing the foreign currency risk.

2.19 In this research paper by Adler & Dumas, currency exposure is defined as the regression coefficient in foreign exchange rates and the value of domestic currency. Refer to Exhibit 3 and Exhibit 4 in Appendix 1 for the calculation of the amount exposed to foreign currency risk when the amount in franc is certain and uncertain, respectively. In both Exhibits, “b” shows the regression coefficient. In Exhibit 3, b is FF 1,000, where as in Exhibit 4, the amount of “b” becomes greater. As the volatility of franc becomes greater, covariance between the dollar amount and the foreign exchange rate also becomes greater, thereby increasing the amount of b to FF 2,000.

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13 Adler, M. and Bernard D., “Exposure to Currency Risk: Definition and Measurement”, Financial Management, summer 1984. p. 42

2.20 The first characteristic of currency exposure defined in this research paper is that currency exposure was seen as an issue of a specific point in time. The second characteristic is that currency exposure was not seen to be confined to financial assets and liabilities denominated in foreign currency, but to be also applied to real assets and liabilities in the same manner. In other words, if the real purchasing power of assets and liabilities changes due to foreign exchange rate changes, they are seen to be subject to currency exposure.

2.21 The above-defined currency exposure may also be defined as economic exposure. The concepts of accounting exposure and economic exposure are compared in Table 2 below. Accounting exposure may be divided into translation exposure and transaction exposure.

<Table 2: Definitions of Currency Exposure>[14]

Translation Exposure	Translation exposure is generally referred to as accounting exposure or balance sheet exposure. Translation exposure arises when translating functional currency financial statements to reporting currency.
Transaction Exposure	Transaction exposure is generally referred to as conversion exposure or cash flow exposure, and is related to cash flows of transactions denominated in foreign currency. Transaction exposure arises due to foreign exchange rate changes within the period between the origination and settlement of a transaction.
Economic Exposure	Economic exposure is generally referred to as operation exposure. Economic exposure refers to a quantity of foreign currency that reflects the degree of change in the real value of assets denominated in domestic currency held by entities when the real

[14] Yoon, S.S., “Research on foreign currency translation by the current rate method”, Master’s degree thesis, Seoul National University, 1981. p. 13~19 and Jung, C.W., “Analysis of currency exposure: cases for Korean companies”, Korea Institute of Finance, 2003 (modified)

	purchasing power of a foreign currency changes due to an unexpected rate change at a certain point in time in the future.

2.22 As shown in Table 2, economic exposure is related to the impact of exchange rate fluctuation on all cash flows following the operation of an entity. Therefore, if changes in exchange rates have an impact on profits of an entity, the entity would be deemed to be exposed to economic exposure, even if it does not hold any assets or liabilities denominated in foreign currency. From this point of view, if it is possible to measure and show the economic exposure of an entity using an accounting method, then it would be possible to reflect the economic effect of changes in exchange rate in its entirety. However, there are many restrictions within the current framework of financial accounting and thus economic exposure is not always shown properly by using an accounting measurement.

2.23 In other words, if we look at economic exposure from the accounting point of view, transactions subject to economic exposure may include not only incurred transactions but also those that have not yet incurred, involving assets and liabilities denominated in foreign currency and domestic currency held by an entity. On the other hand, transactions subject to accounting exposure may include only the incurred transactions involving assets and liabilities denominated in foreign currency and some foreign currency transactions that have not yet incurred. The scope of accounting exposure is shown in Table 3 below.

<Table 3: Scope of Accounting Exposure>

	Assets and liabilities denominated in foreign currency	Assets and liabilities denominated in domestic currency
Incurred transactions	O	X
Transactions not yet incurred	Δ*	X

* Although executory contracts are generally not subject to accounting exposure, some items of executory contracts that are subject to fair value hedge accounting (e.g., firm commitments) are included in the scope of accounting exposure.

2.24 If reflecting the economic effect of a rate change mentioned in SFAS 52 implies the concept of currency exposure, then accounting translation should be able to best reflect economic exposure. However, as mentioned in the above paragraph, transactions subject to economic exposure include transactions that involve assets and liabilities denominated in domestic currency. Thus, the economic exposure of an entity that SFAS 52 intends to show is limited in the assets and liabilities denominated in foreign currency without consideration of assets and liabilities denominated in domestic currency.

2.25 Furthermore, even if one considers economic exposure to be limited to those assets and liabilities denominated in foreign currency which are recognised in the financial statements, one particular translation method may not always show every entity's economic exposure in an appropriate manner. This is because the degree of change in the value of assets and liabilities denominated in foreign currency caused by exchange rate changes would be different among entities depending on the situation unique to each entity. Let us consider the relationship between prices and exchange rates for instance. The degree of change in general price level to the change in exchange rate would depend on situations, and the degree of change in the value of specific assets and liabilities held by entities, i.e., the degree of change in future cash flows, to change in general price level would also be different for each company.[15]

Compatibility in Terms of Cash Flow Consequences

2.26 Another part that should be noted regarding the objective of foreign currency translation in SFAS 52 is the basis for conclusion paragraph (paragraph 71) mentioned in 2.15 concerning paragraph 4a in SFAS 52. In paragraph 71, it is stated that **compatibility in terms of cash flow consequences** is achieved if rate changes that are reasonably expected to impact either functional or reporting currency cash flows are reflected as gains or losses in determining net income for the period, and the effect of rate changes **that have only remote and uncertain implications for realisation are excluded from determining net income for the period**.

[15] Heckman, C.R., "Foreign Exchange Exposure: Accounting Measures and Economic Reality", Journal of Cash Management. Feb/Mar 1983 Vol. 3 no. 1

2.27 We believe that such an objective is appropriate, and the related discussions are set out in Chapter VI in detail.

Point 3: What should be considered when the objective paragraph in IAS 21 is to be improved?

2.28 As discussed in the above section concerning Point 2, while the objective of foreign currency translation in SFAS 52 is closely related to the concept of foreign currency risk and currency exposure, clearly stated definition or meaning of the objective were absent in the standard. Thus, amending the paragraph on the objective of foreign currency translation in IAS 21 would require discussions in the view of foreign currency risk and currency exposure. Furthermore, the objective of translation of foreign currency transactions should be distinctively stated when amending IAS 21 because the objective of foreign currency translation in SFAS 52 is stated only with regard to translation of functional currency financial statements. Lastly, it would be appropriate to carry out this foreign currency accounting project in parallel with the Conceptual Framework project since the objective of foreign currency translation and the Conceptual Framework need to be consistent.

Definition of Foreign Currency risk

2.29 In current IAS 21, there is no definition of foreign currency risk or currency exposure. However, foreign currency risk is defined as below in IFRS 7, and IFRS 7 explains that foreign currency risk arises from financial instruments denominated in a currency for measuring financial instruments other than the functional currency.[16]

> ‘The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.’

2.30 Regarding the definition of foreign currency risk, we need to first clarify whether foreign currency risk referred in IFRS 7 is **different to** or the same as **the definition of**

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[16] IFRS 7 para. B23

economic foreign currency risk. Since the definition in IFRS 7 states that foreign currency risk arises from all financial instruments denominated in foreign currency, there seem to be some differences between this definition and the economic definition of "foreign currency risk that arises from unexpected changes in exchange rates."

2.31 Furthermore, it would be **useful to clarify the relationship between the financial/non-financial distinction and monetary/nonmonetary distinction**. This is so because financial/non-financial distinction determines whether an item denominated in foreign currency is subject to foreign currency risk according to the definition of foreign currency risk in IFRS 7, whereas translation in IAS 21 uses monetary/nonmonetary distinction, thereby possibly causing conceptual confusion.

2.32 For instance, according to the definition of monetary items in paragraph 16 in IAS 21, "a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item." Therefore, the definition of such contract would include executory contracts, and some of the executory contracts are non-financial instruments, unable to meet the definition of financial instruments. However, if the translation method in IAS 21 is applied, all monetary items need to be translated using the closing rate, which would lead one to conclude that executory contracts would also have to be translated. In contrast, according to the definition of foreign currency risk in IFRS 7, such items are not financial instruments, and thus do not carry foreign currency risk. Therefore, one would reach a conclusion that executory contracts are not subject to translation.

<Table 4: Comparison of Monetary/Nonmonetary Items and Financial/Non-financial Items>

Distinction	Monetary Items	Nonmonetary Items
Financial Instruments	- accounts receivable, accounts payable, borrowing, debt instruments, etc.	- equity instruments
Non-financial Instruments	- a contract to receive (or deliver) a variable	- advance payments, goodwill, intangible

Distinction	Monetary Items	Nonmonetary Items
	number or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency (IFRS 21.16)	assets, property, plant and equipment, provisions redeemed upon the delivery of nonmonetary assets, etc. (IFRS 21.16)

2.33 Furthermore, if financial instruments are the only ones to carry foreign currency risk according to the definition in IFRS 7, it would mean that equity instruments, which are nonmonetary financial instruments, also carry foreign currency risk, and consequently, it would be correct to translate equity instruments regardless of whether they are measured at cost or at fair value. However, in IAS 21, nonmonetary items are translated only when they are measured at fair value.

Definition of Currency Exposure

2.34 Currency exposure also requires in-depth discussions. As shown in Point 2, currency exposure may be defined at various levels and there are limits as to accurately showing economic exposure in an accounting sense. Thus, a clear line should be drawn between economic exposure and accounting exposure.

2.35 Since one particular translation method in an accounting sense cannot fully reflect the economic exposure for all entities, defining the objective of foreign currency translation as showing the economic effects of a rate change would be overly comprehensive and may cause a misunderstanding that the current accounting will always reflect the economic exposure in an appropriate manner. In other words, one may misunderstand the amount translated in an accounting sense to be the economic exposure despite the fact that other factors must be considered in determining the degree of economic exposure.

2.36 Thus, even if the objective of foreign currency translation is defined as properly reflecting the economic exposure in IAS 21, the limits to accounting measurement should also be considered in an appropriate manner.

Objective of Translation of Foreign Currency Transactions

2.37 As shown in Point 2, although the objective of translation of foreign currency transactions is not clearly stated in SFAS 52, this report indicated that the objective of translation of functional currency financial statements may be applied to translation of foreign currency transactions.

2.38 However, since the translation method for foreign currency transactions and the translation method for functional currency financial statements are different from each other, it would be more appropriate to specify the objectives of the two accounting treatments separately in order to determine the objective of foreign currency translation in further detail.

Consideration Given to Conceptual Framework

2.39 The objective of foreign currency translation is a conceptual requirement and thus should be consistent with the requirement in the Conceptual Framework.

2.40 In "Conceptual Framework for the Preparation and Presentation of Financial Statements," the objective of financial statements is stated as "to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions"[17] and it is also stated that "The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation."[18] Consistent with this, the focus should be placed on providing information on the size, timing, and uncertainly of cash flows of an entity with regard to translation of foreign currency transactions.

[17] Refer to paragraph 12 in Conceptual Framework for the Preparation and Presentation of Financial Statements
[18] Refer to paragraph 15 in Conceptual Framework for the Preparation and Presentation of Financial Statements

2.41 For instance, the objective of SFAS 52 states that compatibility in terms of cash flow consequences is achieved if rate changes that are reasonably expected to impact either functional or reporting currency cash flows are reflected as gains or losses in determining net income for the period, and the effect of rate changes that have only remote and uncertain implications for realisation are excluded from determining net income for the period. Such requirement may be related to the recognition criteria mentioned in paragraph 85 of the Conceptual Framework that considers the probability of future economic benefit.

2.42 Accordingly, when determining the objective of foreign currency translation in IAS 21, it should be examined in connection with the Conceptual Framework.

Summary

2.43 Because the objective of foreign currency translation is not stated in IAS 21, it is difficult to understand what kind of information is to be provided by the accounting for foreign currency translation in IAS 21.

2.44 By examining SFAS 52, which we considered to be similar to IAS 21, we deemed that the objective of foreign currency translation in SFAS 52 contains the concepts of foreign currency risk and economic exposure.

2.45 We deemed it necessary to discuss the following issues when determining the objective of foreign currency translation in IAS 21:

- Clear and accurate definition of foreign currency risk:
  In current IFRS 7, the definition of foreign currency risk is described as pertinent only to financial instruments. However, there should be clear definitions of terms because foreign currency risk is not mentioned in IAS 21 and if the definition in IFRS 7 is applied to IAS 21, non-financial instruments would be interpreted as carrying no foreign currency risk.

- Consideration of limits to accounting measurement:
  One should consider that economic exposure may not always be properly reflected

in the financial statements.

- Separate definitions for the objective of “translation of foreign currency transactions” and the objective of “translation of functional currency financial statements”:
  Accounting treatments for translation of foreign currency transactions and for translation of functional currency financial statements differ from each other, and consequently, the objectives of the two aforementioned translations ought to be different from each other.

III. Relationship between Foreign Currency Translation & Measurement

Background

3.1 In Chapter II, it was examined that in order to determine the objective of foreign currency translation in IAS 21, the limits to foreign currency translation as a measurement in an accounting sense (i.e. economic exposure may not always be properly reflected in the financial statements) should be considered. Therefore, we would like to examine what the current foreign currency translation method intends to measure, as the subsequent topic.

3.2 In translation of foreign currency transactions, nonmonetary items are translated only when they are measured at fair value (i.e., at the rate on the day that the fair value was determined), whereas all monetary items are translated (i.e., at the closing rate) regardless of how they are measured. To achieve the consistency of measurement, however, one may question whether it would be more appropriate to translate monetary items only when they are measured at fair value.

3.3 A comprehensive review would be necessary in order to explore such question. Thus, discussions would be needed about how to define or understand foreign currency translation in the view of measurement basis within the context of the Conceptual Framework. Considering that foreign currency translation were excluded when measurement bases were discussed in the view of the Conceptual Framework in the IASB's Discussion Paper "Measurement Bases for Financial Accounting – Measurement on Initial Recognition" prepared by the Canadian Accounting Standards Board (AcSB) in 2005[19], foreign currency translation should be discussed at the Conceptual Framework level when IAS 21 is to be amended in the future.

3.4 However, defining foreign currency translation in the view of measurement within the context of the Conceptual Framework would require a great deal of discussion and research. As a consequence, we thought that, even though it would be difficult to fully discuss the topic in this report, it would be useful to examine the measurement basis

[19] IASB, "Discussion Paper: Measurement Bases for Financial Accounting – Measurement on Initial Recognition (condensed version)", November 2005. Para. 3

assumed by IAS 21 or by the translation method of the U.S. GAAP standard as well as what has been discussed in academic papers in order to provide the foundation for further research.

3.5 Thus, we examined the following issues:

- Point 1: What is the viewpoint of measurement in translation of foreign currency transactions in SFAS 52?
- Point 2: Characteristics and issues in the viewpoint of the temporal method
- Point 3: Issues in the viewpoint of fair value measurement
- Point 4: Academic research papers in the context of the relationship between foreign currency translation method and measurement

Issues

Point 1: What is the viewpoint of measurement in translation of foreign currency transactions in SFAS 52?

3.6 Translation of foreign currency transactions in SFAS 52 is examined herein because, as discussed in Chapter II, the objective of foreign currency translation in SFAS 52 seems similar to that of IAS 21, and also because the translation method in SFAS 52 seems similar to that of IAS 21.

3.7 However, SFAS 52 does not seem to approach the issue of translation of foreign currency transactions from the viewpoint of what is to be measured. It merely explains the basis of how foreign exchange gains or losses incurred from foreign currency transactions would be recognised. In SFAS 52, it is stated that foreign exchange gains and losses incurred from foreign currency transactions should be reflected in determining net income for the period since the economic nature of translation gains and losses incurred from translation of foreign currency transactions is different to the nature of translation adjustments arisen from translation of functional currency financial statements.

3.8 Therefore, we concluded that there is a need to examine what is to be measured by translation of foreign currency transactions in SFAS 52.

The Viewpoint of the Temporal Method

3.9 We first placed the focus on SFAS 8, which was replaced by SFAS 52. It was because, while the translation methods between SFAS 52 and SFAS 8 are different to each other regarding translation of functional currency financial statements, the methods of translation of foreign currency transactions in SFAS 52 and SFAS 8 are similar to each other.[20] (Refer to the comparison of IAS 21, SFAS 52, and SFAS 8 in Appendix 2) Furthermore, we decided that temporal method, which is the principle for the translation method in SFAS 8, may be regarded as one viewpoint about what is to be measured by translation.

3.10 The temporal method may be briefly described as a method used to maintain the measurement basis used in measuring items on foreign currency financial statements even after the financial statements are translated. For instance, when an item is measured at a price that reflects the current time (e.g., current selling price) on foreign currency financial statements, the item should also be measured at a price that reflects the current time on the translated financial statements. Thus, such item is to be translated using the current exchange rate instead of historical exchange rates.

3.11 Under such principle, the method of foreign currency translation is specified in SFAS 8 as follows.

- Recorded dollar balances representing cash and amounts owed by or to the enterprise that are denominated in foreign currency shall be adjusted to reflect the current rate.
- Assets carried at market whose current market price is stated in a foreign currency shall be adjusted to the equivalent dollar market price at the balance sheet date (that is, the foreign currency market price at the balance sheet date multiplied by the current rate).

3.12 Then, **could translation of foreign currency transactions in SFAS 52 be considered as following the temporal method?** If so, the basis of considering translation of

[20] Unlike SFAS 52, SFAS 8 does not distinguish translation of foreign currency transactions and translation of functional currency statements.

foreign currency transaction in SFAS 52 as the temporal method extends beyond the assumption that the accounting treatments in both standards of SFAS 8 and SFAS 52 are likely to be the same. The remeasurement (i.e., a process for translating foreign currency financial statements to functional currency financial statements) [21] requirement in SFAS 52 relates to a principle that the carrying amount recorded in foreign currency must be the same as the carrying amount initially recorded in functional currency after remeasurement. We supposed that this principle is similar to the description of the temporal method in SFAS 8 which stated that the same measurement basis must be maintained even after translation. Furthermore, analyses in some academic papers explicitly state that translation of foreign currency transactions in SFAS 52 is the same temporal method as that in SFAS 8.[22]

3.13 Therefore, it may be possible to consider translation of foreign currency transactions in SFAS 52 to be **in line with the temporal method, just as SFAS 8**.

The Viewpoint of Fair Value Measurement

3.14 Even if the result of accounting for translation of foreign currency transactions in SFAS 52 and SFAS 8 are the same, it would be possible not to view the principle in SFAS 52 as the temporal method. It may be so because the temporal method is not explicitly referred in SFAS 52 and the objective of foreign currency translation in SFAS 52 is stated differently to that in SFAS 8.

3.15 Then, what is translation of foreign currency transaction in SFAS 52 supposed to measure? One viewpoint is to consider **foreign currency translation as fair value measurement**. Given this viewpoint, the reason for not describing foreign currency transactions as fair value measurement in SFAS 52 may be explained as follows. The reason is that there were not many items measured at fair value and the topic of fair value measurement was not widely discussed at the time when SFAS 52 was issued. Therefore, the viewpoint of fair value measurement is not explicitly touched upon, but

[21] The reason for referring to 'remeasurement' requirement is because SFAS 52 specifies requirement for monetary items in the section of translation of foreign currency transactions. That is, for the translation of foreign currency transactions for nonmonetary items, 'remeasurement' requirements should be referred to.

[22] Selling, Thomas I., and George H. Sorter, "FASB Statement No. 52 and its Implications for Financial Statements Analysis", Financial Analysts Journal 1983: May-June

tacitly implied in SFAS 52.

3.16 Viewing foreign currency translation as fair value measurement means that a change in exchange rates is viewed as a component of fair value changes. Such a viewpoint can be confirmed by other standards. First of all, EITF 96-15 in U.S. GAAP, relating to foreign exchange gains or losses of available for sale debt securities, may be referred to. This interpretation covers "Whether the entire change in the fair value of AFS debt securities should be reported in a separate component of stockholders' equity or whether the portion attributable to changes in exchange rates should be reported in earnings as a foreign currency transaction gain or loss."[23] According to this EITF, exchange rate changes are described as part of fair value changes. Furthermore, IAS 39 also provides a basis for this viewpoint because it regards exchange rate change as a hedged item in fair value hedge accounting.

Point 2: Characteristics and issues in the viewpoint of the temporal method

Characteristics in the Viewpoint of the Temporal Method

3.17 Now, how should the temporal method be viewed from the point of measurement? As described above, the temporal method is used to have the measurement basis, applied to foreign currency items before translation, maintained even after the translation. In other words, the temporal method is just changing the unit of measurement.[24] **The first characteristic of the temporal method** is that it **considers the consistency between the amount before the translation and after the translation in terms of temporality**.

3.18 Translating all items using the current exchange rate, just like in translation of functional currency financial statements in SFAS 52, would be in line with the

[23] EITF 96-15 describes as follows. "The issues are: 1. Whether the entire change in the fair value of AFS debt securities should be reported in a separate component of stockholders' equity or whether the portion attributable to changes in exchange rates, that is, part (2) above, should be reported in earnings as a foreign currency transaction gain or loss"

[24] Paragraph 6 of SFAS 8 describes as follows.
"6. For the purpose of preparing an enterprise's financial statements, the objective of translation is to measure and express (a) in dollars and (b) in conformity with U.S. generally accepted accounting principles the assets, liabilities, revenue, or expenses that are measured or denominated in foreign currency. Remeasuring in dollars the assets, liabilities, revenue, or expenses measured or denominated in foreign currency should not affect either the measurement bases for assets and liabilities or the timing of revenue and expense recognition otherwise required by generally accepted accounting principles. That is, translation should change the unit of measure without changing accounting principles."

viewpoint that foreign currency risk should be measured treating a rate change as a separate event. However, if items that are measured at historical cost are also translated using the current exchange rate in accordance with the above, it would become unclear as to how to interpret the amounts recognised in the financial statements after the translation. That is, the amount recognised in the financial statements by only measuring a change in foreign exchange rate without reflecting any other changes in (fair value) components, would represent neither a fair value nor a historical cost.

3.19 In contrast, if items that are measured at historical cost are translated at historical cost in accordance with the temporal method, the measured amounts would be able to show the historical cost in the translated currency, and thus help enhance the understandability of the amounts on the translated financial statements from a conceptual standpoint.

3.20 Let us examine this in detail using SFAS 8 as an example. If an entity in the U.K purchased a piece of land for 1,000,000 pounds (GBP 1 = $2.8), the equivalent dollar cost of the land would be $2,800,000. If this piece of land is measured at historical cost and the exchange rate at the end of the period is GBP 1 = $2.35, the amount recognised on the dollar financial statements would be $2,350,000. However, the current equivalent dollar price could be greater or smaller than $2,350,000. That is, if the current value of the land denominated in pounds becomes 2,000,000 pounds instead of 1,000,000 pounds at the end of the period, the current equivalent dollar price would be $4,700,000.[25]

3.21 Another characteristic of the temporal method which can be learned from the above comparison between SFAS 52 and SFAS 8 is that the translation is regarded as an inevitable accounting procedure that must be executed to state the amounts in one currency, rather than as measuring foreign currency risk. Under the temporal method, translating at the current rate incidentally results in measuring foreign currency risk, but the major objective is to change the unit of measure, not to measure foreign currency risk or a certain accounting event.

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[25] Refer to SFAS 8 para. 148

3.22 Therefore, if the objective of foreign currency translation is to properly reflect the economic exposure, then this objective would not be consistent with the viewpoint of the temporal method. Furthermore, the lack of discussion on foreign currency risk or currency exposure in IAS 21 may cause one to believe that IAS 21 has tacitly adopted the viewpoint of temporal method because the temporal method is not inherently related to the concept of foreign currency risk or currency exposure.

Issue in the Viewpoint of the Temporal Method

3.23 On the assumption that the translation method in IAS 21 follows the temporal method, everything would be explainable as for translation of nonmonetary items. For nonmonetary items, items that are measured at historical cost are translated at historical cost and items that are measured at fair value are translated at the rate of the day that the fair value was determined. In contrast, all monetary items are translated at the current rate without any distinction. Then, **what is the reason for requiring translation of all monetary items at the current rate without any specific distinction?**

3.24 Although SFAS 8 explains the reason for translating monetary items at the current rate, it is not sufficient to provide a valid reason. The reason is explained in only one of the paragraphs in SFAS 8. It states that there is a 'general agreement' as to translating monetary items at the current exchange rate[26], without providing specific grounds.

3.25 The specific grounds for the 'general agreement' stated in SFAS 8 may be found in ARS No. 12[27], which laid the foundation for issuing SFAS 8. ARS No. 12 provided the grounds for the translation method by explaining in detail as to why monetary items should be translated at the current rate under the principle of temporal method.

3.26 In ARS No. 12, it was analyzed that there are conflicting opinions regarding the then standards about whether receivables or payables are measured at the future value or at the current value. APB 4 analyzes that receivables or payables are measured at the

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[26] Refer to para. 85, SFAS 8

[27] Lorensen, L., "Reporting foreign operations of US companies in US dollars", Accounting Research Study No. 12, 1972.

future value. APB 4 describes that such items are measured at net realisable value, and that such measurement is not always the same as the current selling price. Such measurement is the same as the current selling price 'only when the future selling price is expected to be the same as the current selling price.' Therefore, it is clearly stated that the net realisable value and the current selling price are conceptually different from each other. APB 3, however, states that receivables or payables should be measured using the general price-level index applicable on the balance sheet date in general price-level accounting. Consequently, APB 3 analyzes that receivables and payables are treated as the items that are evaluated at the current value rather than the future value.

3.27 Taking the conflicting opinions as well as other relevant standards into consideration, ARS No. 12 decides that it is more appropriate to have receivables and payables measured at the current price, and under such presumption, provides a translation method in accordance with the temporal method.

3.28 According to the analysis in ARS No. 12, monetary items are measured at net realisable value. By examining whether the net realisable value is the current price or the future price, one could see that the net realisable value is deemed to be the current price. Such analysis would be appropriate for short-term receivables or payables. Such items were presumed to be measured at the current price because the items may be measured at a non-discounted amount (i.e., net realisable value) and thus may cause a dispute over whether the amount is the present price or the future price. Accordingly, under the principle of the temporal method, the analysis in ARS No. 12 shows that it is appropriate to translate receivables and payables at the current exchange rate.

3.29 Then, are all monetary items measured at net realisable value? It should be noted that in the case of long-term monetary items, they are not measured at net realisable value but at amortised cost by discounting the future payable amount. Could this amount be considered to be measured at current value? Could the amount be considered to be measured at current value even though it was discounted by historical effective interest rate?

3.30 In SFAS 8, translating long-term liabilities measured at amortised cost using historical exchange rate is described to be inappropriate because it is not related to the current dollar amount corresponding to the remaining interest and principal. Furthermore, SFAS 8 described that if the exchange rate is not reversed, the above approach would only cause delays in recognition of translation gains and losses until the liabilities are settled.[28]

3.31 However, some academic research papers argue differently regarding translation of long-term monetary liabilities. W. H. Beaver (1984)[29] argues that long-term monetary items are measured at historical cost and thus it is difficult to interpret the meaning of gains and losses incurred by translating the long-term monetary items at the current rate when the historical cost of the items is significantly different to the current market value.

3.32 Furthermore, J.P. Nance (2008)[30] argues that, although it would be appropriate to translate long-term liabilities using the current exchange rate if the long-term liabilities are measured by discounting at the market interest rate, long-term liabilities are measured at cost or amortised cost.

3.33 Therefore, if the method of translation of foreign currency transactions in IAS 21 is assumed to be the temporal method, then it may be possible to argue that it is not conceptually valid to translate long-term monetary foreign currency items (e.g., items measured at amortised cost) at the current exchange rate. Consequently, additional discussions would be needed regarding this matter.

Point 3: Issues in the viewpoint of fair value measurement

3.34 **The first issue** that arises when viewing translation of foreign currency transactions as fair value measurement is that **the applicable principle for nonmonetary items and the applicable principle for monetary items would differ from each other.**

3.35 First, when the basis for translation of monetary items is interpreted from the viewpoint

28 Refer to para. 131, SFAS 8
29 Beaver, W. and Wolfson M., "Foreign currency translation gains and losses: What effect do they have and what do they mean?", Financial Analysts Journal, 1984: March-April
30 Nance, J.P. and Roemmich R.A., "Are financial statements meaningful under exchange rate fluctuations?:Financial analysis", Journal of Financial Management and Analysis, 2008: 65-74

of fair value measurement, it is on the presumption that measuring at least some fair value components, i.e., exchange rate changes, would help provide more useful information even if other fair value components are not reflected in the financial statements. That is, in this viewpoint, it is more appropriate to measure fair value fluctuations, i.e., exchange rate changes, even for monetary items not measured at fair value in their entirety.

3.36 However, the viewpoint of reflecting some fair value components as implied by the principle for monetary items may not be applied as it is to nonmonetary items. The reason is that, according to such viewpoint, nonmonetary foreign currency items measured at historical cost should also be translated at the closing rate. For instance, a component of fair value changes, i.e., exchange rate fluctuations, would also have to be accounted for equity instruments which are measured at cost in accordance with IAS 39.

3.37 Therefore, when the method of translation of nonmonetary items is interpreted from the viewpoint of fair value measurement, the items would have to be measured at fair value and thus exchange rate fluctuation would also have to be measured at fair value. In other words, if a nonmonetary item is required to be measured at fair value in another relevant standard, then exchange rate changes should also be measured accordingly since a change in exchange rate is part of a change in fair value.

3.38 Then how could the difference between the views regarding monetary and nonmonetary items be resolved? One possible method is **not to distinctively specify nonmonetary items in foreign currency translation standards**. Under this method, a change in exchange rate would be accounted for in accordance with relevant standards. Another possible method is **to translate all monetary and nonmonetary items at the current exchange rate (or at the rate of the day that the fair value was determined) without distinction.** This type of method would have to be specified in foreign currency translation standards. This is so because such requirement specifies measuring exchange rate changes even if they are not measured at fair value in other standards.

3.39 **The second issue** that arises when viewing translation of foreign currency transactions as fair value measurement is about the **accounting treatment when the current market exchange rate is unable to reflect fair value**. While the current IAS 21 states which one of the exchange rates at different points in time (i.e., historical rate, closing rate, or the rate of the day that the fair value was determined) should be used, there are no requirements as to which exchange rate should be used at certain points in time.

3.40 In IFRS 13, the fair value measurement standard, when the market price is unable to reflect fair value, the fair value is estimated using valuation methods, and etc.[31] The standard also states that when the volume or level of activity significantly decreases, fair value may be affected.[32] If IFRS 13 is applied to the case of exchange rate market, there may be the situations where the market price in the exchange rate market does not reflect fair value. For example, significant decrease of foreign currency liquidity in the foreign exchange market may be understood as corresponding to significantly decreased volume or level of activity in IFRS 13. Thus, additional assessment may be needed to determine whether the market price reflects fair value.

3.41 In the current IAS 21, however, no other exchange rate may be used when the official exchange rate in the market does not represent fair value. Thus, **if IAS 21 is in line with the viewpoint of perceiving exchange rate change as fair value change, then IAS 21 would need to define cases in which prices other than the market price may be used and how fair value is estimated in such cases**.

3.42 In the meantime, the absence of a translation method for nonmonetary items that are measured neither at historical cost nor at fair value should also be discussed. Regarding translation of foreign currency transactions involving nonmonetary items in the current IAS 21, translation methods for only the items measured at historical cost and at fair value are specified, and there are no translation method provided for items that are measured by other measurement basis. For example, though the amount of a provision measured in accordance with IAS 37 may be similar to its fair value, the amount is unlikely to be defined as fair value because the amount is the optimal estimate to perform the present obligation. Therefore, there is an absence of a requirement as to which exchange rate should be applied for such nonmonetary items in foreign currency.

Point 4: The relationship between foreign currency translation method and measurement

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[31] IFRS 13 para.79

[32] IFRS 13 para. B37

in academic papers

3.43 We first referred to the research paper by W. H. Beaver (1982)[33] to examine the relationship between foreign currency translation and measurement. In this paper, a number of translation methods are evaluated by applying the following two criteria on the assumption that exchange rate changes are exclusively determined by differential inflation rates among countries. The first criterion is economic interpretability. The economic interpretability means that the carrying amounts on the balance sheet should be the same as the present value of the future cash flows of assets, liabilities, and net assets, and also that revenues generated from investments, which are reported in the financial statements and denominated in the domestic currency, should be the same as the nominal ROI of the investments. Second criterion is symmetry. In order to fulfill the symmetry criterion, investing in two economically identical assets (e.g., investing in an asset located overseas and in another asset located at home, with other conditions of the two investments being identical) should result in the same amounts in the financial statements when the two assets are translated into the same currency.

3.44 Beaver's paper demonstrates that the two criteria are fulfilled only when the current cost/current rate method (C/C method) is used, which is to measure at the current cost and translate at the current rate. The paper also shows that when the historical cost/historical rate method (H/H method) is used, it would only fulfill the symmetry criteria but not the economic interpretability criteria, and when the historical cost/current rate method (H/C method) is used, none of the two criteria may be fulfilled. This is shown in Table 5 below.

<Table 5: Comparison of Measurement/Translation Methods>

Method	Economic Interpretability	Symmetry
C/C method	Yes	Yes
H/H method	No	Yes
H/C method	No	No

[33] Beaver, W.H. and Wolfoson M., "Foreign Currency Translation and Changing Prices in perfect and Complete Markets", Journal of Accounting Research, Autumn 1982: Vol. 20 No. 2, pp. 528-550

3.45 However, this assessment is only valid under a very strict assumption. That is, Beaver's paper is premised on the assumption that exchange rates are determined exclusively by differential inflation rates among countries. Glick (1986)[34] demonstrates that the C/C method is able to achieve the objective of the two criteria of economic interpretability and symmetry only when the assumption that each country's inflation leads to proportionate change in the price of assets and liabilities owned by each entity (i.e., inflation neutrality), in addition to the assumption that exchange rates are determined exclusively by differential inflation rates (i.e., exchange neutrality, also known as purchasing power parity).

3.46 Ziebart (1998)[35] points out that even the C/C method, which is the most ideal measurement/translation method, is valid only when very strict conditions are met and thus even if such method is applied, additional disclosures are needed in order to provide meaningful accounting information. Ziebart suggested that disclosures, for example, of the historical rate at the time when an asset was acquired, the current rate on the balance sheet date, and a schedule of when the assets of the entity were acquired would provide useful information to users in assessing the performance and financial position of a foreign operation.

3.47 What we can learn from these academic research papers is that even if one chooses to apply an accounting method that is supposed to show the most accurate economic substance, which is to measure all items at fair value and translate exchange rate fluctuations at the current rate, such method still would not be able to always show foreign currency risk and economic exposure in an appropriate manner.

Summary

3.48 IAS 21 lacks conceptual discussions on measurement basis for foreign currency translation methods.

[34] Glick, R. "Market neutrality Conditions and Valuation of a Foreign Affiliate", Jouarnal of Business, Finance, and Accounting 1986: Summer 239-249

[35] Ziebart, David A., and Jong-Hag Choi, "The difficulty of Achieving Economic Reality through Foreign Currency Translation", The International Journal of Accounting, 1998, Vol 33, No 4, pp.403-414

3.49 Translation in IAS 21 may be conceptually defined from the following two viewpoints of measurement:

(a) Viewpoint of the temporal method
(b) Viewpoint of fair value measurement

3.50 From the viewpoint of the temporal method, translation is viewed more as an inevitable accounting procedure that must be executed to state amounts in one currency rather than translating foreign currency risk. Therefore, using the economic exposure concept in determining the objective of foreign currency translation would be inconsistent with such a view.

3.51 **The first issue** that arises in the viewpoint of fair value is that **the applicable principle for nonmonetary items and the applicable principle for monetary items would differ from each other**.

- Monetary item: The principle applied to monetary items views reflecting some changes in fair value as useful. In other words, it assumes that, even though an item is not measured at fair value, recognition of a change in exchange rate, i.e. a part of total fair value changes, provides more useful information.

- Nonmonetary item: The principle applied to nonmonetary items views it inappropriate to reflect only some fair value changes. In other words, it assumes that if an item is not measured at fair value, recognition of a change in exchange rate, i.e. only a part of fair value changes, does not provide useful information.

3.52 To resolve such issues, the following two methods may be considered: one method is to exclude any requirements related to nonmonetary items from IAS 21; and another method is to translate all monetary and nonmonetary items at the current exchange rate without distinction.

3.53 **The second issue** that arises in the viewpoint of fair value is about **accounting treatment when the market exchange rate is unable to reflect fair value**.

- According to IFRS 13, the fair value measurement standard, when the market price is unable to represent fair value, the fair value is calculated using valuation techniques.
- When the volume or level of activity in the market has significantly decreased, it may indicate that the market price does not represent fair value.
- IFRS 13 may be applied to the exchange rate market when liquidity significantly decreases due to intensified fluctuations in exchange rates.
- In IAS 21, however, there is no consideration given to this issue.

3.54 To resolve this issue, cases in which the market exchange rate is unable to represent fair value should be defined and alternative accounting treatments thereof should be determined in IAS 21 based on IFRS 13.

3.55 We also discovered that IAS 21, specifying only the translation methods for items measured at historical cost and at fair value, lacks explicit requirements for nonmonetary items measured in terms of other measurement basis (e.g., provisions in compliance with IAS 37).

3.56 In the review of the academic papers, it is viewed that, for translated amounts to have economic interpretability and symmetry, all items have to be evaluated at the current value and translated at the current exchange rate. Even in such cases, however, the assumptions about exchange rates and prices have to be met in order for the above view to gain validity. Thus, it is viewed difficult to fulfill the economic interpretability and symmetry criteria through translation in practice.

IV. Distinction Between Monetary Items and Nonmonetary Items

Background

4.1 Basically, IAS 21 specifies the requirements for translation of foreign currency transactions depending on the distinction of monetary and nonmonetary items. This does not mean that translation methods vary exclusively according to the distinction of monetary and nonmonetary items since nonmonetary items measured at fair value are translated at the rate of the day that the fair value was measured. Therefore, the requirements in IAS 21 may not be referred to as monetary/nonmonetary method in the strict sense, but may be described as a method similar to that of SFAS 52. Furthermore, since the result of translation of foreign currency transactions in SFAS 52 and SFAS 8 are regarded to be quite similar, the result of translation of foreign currency transactions in IAS 21 and SFAS 8 may be deemed as being similar to each other.

4.2 However, while IAS 21 includes the definition and explanation of monetary items, it does not include any reasons for specifying different translation methods according to the distinction of monetary and nonmonetary items.

4.3 The reason for conducting the review of the monetary and nonmonetary concepts is because there are cases in which the distinction between monetary and nonmonetary items is ambiguous. For example, according to the implementation guidance in IAS 39, foreign currency denominated available for sale debt instrument is considered as monetary and thus the resulting foreign exchange gains and losses are reflected in profit or loss for the period instead of other comprehensive income. However, considering the definition of available for sale instrument, such debt instrument may be deemed as nonmonetary because gain or loss may be generated by selling the debt instrument rather than receiving a fixed amount upon its maturity. If such debt instruments are viewed as nonmonetary, the resulting foreign exchange gains and losses should be reflected in other comprehensive.

4.4 Consequently, the following issues were explored regarding the monetary and nonmonetary concepts.

- Point 1: The historical background of using the monetary and nonmonetary concepts
- Point 2: Usefulness of distinguishing between the monetary and the nonmonetary

Issues

Point 1: The historical background of using the monetary and nonmonetary concepts

4.5 There is a need to first understand the historical background from which the distinction of the monetary and nonmonetary derived. Before the monetary/nonmonetary method, the current/noncurrent method was used in the U.S. According to the current/noncurrent method, current assets and liabilities are translated at the current exchange rate and non-current assets and liabilities are translated at historical exchange rate. This requirement was specified in ARB 4 in 1939 and then in Chapter 12 of ARB 43 in 1953 in the U.S. GAAP.[36]

4.6 The accounting standards associated with foreign currency accounting started to regain attention because of the instability of the exchange rate regime. The Bretton Woods system, a fixed exchange rate system, was working quite well for a few years since it took effect in 1944, but as nations started to devalue their currencies against the dollar, the exchange rate market became unstable. Consequently, doubts were raised as to the relevance of the current/noncurrent method, and in the 1950s, Baxter & Yamey (1951) and Hepworth (1956)[37] proposed the monetary/nonmonetary method. However, the monetary/nonmonetary method was incorporated into APB Opinion No. 6 much later in 1965. Yet the two methods were both accepted and used in practice.

4.7 The monetary/nonmonetary method was regarded as an alternative to remedy the shortcomings of the former method. The current/noncurrent method's weaknesses are that inventories measured at historical cost are translated at the current exchange rate, and that long-term liabilities are not translated. In contrast, inventories are translated at historical cost and long-term liabilities are translated at the current rate according to the

[36] Jackson, Todd, and Doris M. Cook, "A brief history of accounting for the translation of foreign currencies", Journal of Management History 1998: Vol 4. No. 2 pp. 137-144

[37] Hepworth, S.R., "Reporting Foreign Operations, 1956, University of Michigan, Ann Arbor, MI

monetary/nonmonetary method.[38]

4.8 In the meantime, the international exchange rate regime grew even more unstable. In the 1960s, the U.S. government spending sharply increased due to the Vietnam War and etc., and thus its inflation rate grew relatively higher than other nations. The U.S. exports decreased and imports increased. As a result, it became impossible to maintain the fixed exchange rate system around the world, and in 1973, a floating currency regime was adopted through the Smithsonian Agreement.

4.9 There were demands that a comprehensive review should be carried out regarding the standards associated with foreign currency accounting under such rapidly evolving exchange rate regime, and Accounting Research Study (ARS) No. 12 was published in 1972 to meet such demands. In ARS No. 12, it was argued that none of the current/noncurrent method and monetary/nonmonetary method could be appropriate principles. It presented two reasons for the case of monetary/nonmonetary method. First, many assets and liabilities have both monetary and nonmonetary characteristics. For instance, bonds or negotiable notes have a monetary characteristic since they provide a contractual right to receive a fixed monetary amount, but at the same time, they also have a nonmonetary characteristic because their selling prices may vary. Second, nonmonetary assets and liabilities are not measured by a single measurement basis. If nonmonetary items are measured at historical cost, then it would be logical to translate them at historical rate. However, if nonmonetary items are measured at the current market rate, it would not be appropriate to translate the items at historical exchange rate.[39]

4.10 Accordingly, the temporal method was proposed in ARS No. 12 as an alternative to the existing translation method, and a principle was specified in this study that foreign currency items should be measured at their equivalent dollar prices in translated financial statements depending on how they were measured in foreign currency financial statements, e.g., at the current replacement cost, current selling price, or net realisable value, etc.

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[38] Refer to para. 129, SFAS 8

[39] Refer to pp. 34, ARS No. 12

4.11 In SFAS 8 issued in 1975, translation methods are not based on the distinction of the monetary and nonmonetary because SFAS 8 follows the temporal method proposed in ARS No. 12. However, in SFAS 52, translation methods are explained using the monetary/nonmonetary concept with regard to translation of foreign currency transactions. The monetary/nonmonetary concept is also used in translation of foreign currency transactions in IAS 21.

Point 2: Usefulness of distinguishing between the monetary and the nonmonetary

Clarification of Concepts

4.12 The monetary/nonmonetary translation method used before the issuance of SFAS 8 was: not translating any nonmonetary items regardless of how they are measured; and translating all monetary items regardless of how they are measured. The validity of this translation method is backed up by the purchasing power parity theory and the interest rate parity theory. For example, on the assumption that the purchasing power parity theory is valid, it was argued that nonmonetary items should be translated at historical exchange rate because when the exchange rate declines by 10%, a nonmonetary item's foreign currency price will increase by 10%, thereby offsetting the foreign exchange losses, and thus there is no need to recognise the foreign exchange gains and losses of nonmonetary items.[40] In other words, this argument is based on the assumption that fluctuations of the general price level and specific price level are the same.

4.13 However, nonmonetary items are not always translated at historical exchange rate but translated only when they are measured at fair value according to SFAS 52 or IAS 21. Therefore the above method may not be explained with the purchasing power parity theory because the validity of the purchasing power parity theory would not vary depending on different accounting measurement methods.

4.14 We believe that there is a need to assess the reasons for SFAS 52 or IAS 21 to bring the monetary/nonmonetary concept back, which was not used by SFAS 8 adopting the temporal method. And such assessment should be pursued in line with assessment of

[40] Aliber, Robert, and Stickney Clyde, "Accounting measures of foreign exchange exposure: the long and short of it.", The Accounting Review 1975: Jan pp.44-57

the issues discussed in Chapter III of this report.

4.15 As discussed in Chapter III, the principle of translation of foreign currency transactions applied in SFAS 52 or IAS 21 may be viewed as the temporal method or fair value measurement. However, considering from the viewpoint that the principle of temporal method was adopted in these standards, usage of the monetary/nonmonetary concept could lead to conceptual confusion because the standards may be misinterpreted as following the monetary/nonmonetary method. Therefore, we believe that terms in IAS 21 should be carefully chosen in accordance with the principle of temporal method. Considering from the viewpoint of fair value measurement, there is an issue of having to apply different principles to monetary items and nonmonetary items, as pointed out in Chapter III. However, the issue discussed in Chapter III had the inherent assumption that the principles should not vary according to the distinction of monetary and nonmonetary items. Thus, if it is valid to have the principles vary according to the monetary/nonmonetary distinction, then a reasonable explanation should be provided as to why the principles should vary on what conditions.

Difficulties of Monetary/nonmonetary Distinction in Practice

4.16 As argued in ARS No. 12, another weakness of the monetary/nonmonetary concept is that it is difficult to clearly distinguish an item as monetary or nonmonetary if the item has both monetary and nonmonetary characteristics.

4.17 In addition to the foreign currency denominated available for sale debt instrument case discussed in 4.3, issuers of convertible bonds (CBs) would also feel uncertain about whether their bonds should be treated as monetary items under the monetary/nonmonetary definitions. For example, when exercise of the conversion right is almost certain, it could be more appropriate to deem the CBs as nonmonetary items because the issuers of the CBs would no longer have to pay the debt component in quantities of monetary units.

In Relation to Other Standards

4.18 Furthermore, there are ambiguities found when applying certain requirements from other standards using the monetary/nonmonetary distinction defined in IAS 21.

4.19 In IAS 21, pensions that provide benefits in cash are distinguished as monetary items.[41] However in IAS 19, it is specified that plan assets of a defined benefit plan may include both monetary and nonmonetary assets, and that assets and liabilities under defined benefit plans are measured at the current value and translated at the current exchange rate. Moreover, actuarial gains and losses are specified in IAS 19 to be recognised in profit or loss or other comprehensive income. In IAS 21 however, there is no clear requirement regarding such accounting treatment specified in IAS 19.

Summary

4.20 IAS 21 may cause confusion because the standard uses the monetary/nonmonetary concept even though it does not follow the monetary/nonmonetary method (i.e., the method that does not translate any nonmonetary items but translate all monetary items). There are also cases in which the distinction between monetary and nonmonetary items is ambiguous. Therefore, we suggest clarifying the theoretical basis for using the monetary/nonmonetary concept, and seeking alternatives to the monetary/nonmonetary distinction.

- Clarification of theoretical basis for using the monetary/nonmonetary concept:
  It was possible to explain the monetary/nonmonetary method used in the past with theories like the purchasing power parity because none of the nonmonetary items are translated according to the method.[42] However, under the current foreign currency translation method, such theories cannot provide a basis because those nonmonetary items measured at fair value are translated, rather than not translating nonmonetary items as a whole.

- Consideration to be given to alternatives to the monetary/nonmonetary distinction:

[41] Refer to para. 6, IAS 21

[42] Under the assumption that the purchasing power parity holds, a change in foreign exchange rate is exactly offset by a change in price of the foreign currency of an item, which justifies non-translation for that item. For example, when foreign exchange rate decreases by 10%, the price of the foreign currency of a nonmonetary item increases by 10%, offsetting foreign exchange loss, and consequently it is unnecessary to translate the nonmonetary item.

There are cases in which the distinction between monetary and nonmonetary items is ambiguous when an item has both monetary and nonmonetary characteristics (e.g., foreign currency denominated available for sale debt instrument).

V. Definition of Functional Currency

Background

5.1 In IAS 21, foreign operation determines the unit of functional currency, and a foreign operation is defined as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.[43]

5.2 A question was raised about this definition – when interpreting the definition of a foreign operation, should the functional currency be viewed to be determined by this specific form of foreign operation in a limited sense? That is, a question was raised as to whether a legal form of foreign operation is entitled to one functional currency or a plurality of functional currencies.

5.3 Consequently, we carried out a review of the following issue:

- Point 1: Is the definition of a foreign operation in IAS 21 appropriate?

Issues

5.4 A foreign operation is defined in IAS 21 as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity. Therefore it may be interpreted as that those other than the legal entities specified in the definition may not be defined as foreign operations.

5.5 However, considering that foreign operation is a factor in determining the functional currency and functional currency is determined by economic substance, we concluded that foreign operations should not have to be limited to the specific forms of legal entities described in the above definition.

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[43] Refer to para. 8, IAS 21

5.6 As the basis for our conclusion, "Exposure Draft: Conceptual Framework for Financial Reporting – The Reporting Entity," published by the IASB, may be referred to. In this exposure draft, "a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished objectively from the rest of the entity."[44] Thus, when this definition is applied to the case of foreign operation, it would be possible for a division of a foreign operation to have a separate functional currency if the division's economic activities are objectively distinguishable from the rest of the foreign operation.

5.7 SFAS 52 may also be referred to in relation to this issue. It is explained in paragraph 43 of SFAS 52, that "in some instances, a foreign entity might have more than one distinct and separable operation. For example, a foreign entity might have one operation that sells parent-company-produced products and another operation that manufactures and sells foreign-entity-produced products. If those two operations are conducted in different economic environments, those two operations might have different functional currencies."

5.8 Therefore, considering the concept of functional currency, it would be more appropriate to amend the definition of foreign operations in IAS 21 in a manner that a unit separable in terms of economic substance can have a separate functional currency.

<u>Summary</u>

5.9 The definition of foreign operation in IAS 21 seems to be interpreted as if only the specified forms of legal entities are eligible as foreign operations. However, we came to a conclusion that the unit of functional currency may be determined according to economic substance, based on the recent exposure draft of the IASB on Conceptual Framework as well as the requirements in SFAS 52. Therefore, we believe it would be more appropriate to allow more than one functional currency to be used within one legal foreign operation.

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[44] Refer to paragraph RE6 of "Exposure Draft: Conceptual Framework for Financial Reporting – The Reporting Entity" by IASB, 2010:

"**RE6** A portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished objectively from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity. For example, a potential equity investor could be considering a purchase of a branch or division of an entity."

VI. Recognition of Foreign Exchange Gains or Losses

Background

6.1 The starting point of this discussion on the need to improve the standards associated with foreign currency accounting was the criticism that the accounting treatment which determines the method for recognising foreign exchange gains and losses may not be able to reflect economic substance. This issue was mostly raised from emerging economies which had to experience fluctuation in profit or loss due to immediate recognition of exchange gains or losses resulting from significant fluctuation of exchange rates.

6.2 Then, is the method for recognising foreign exchange gains and losses in IAS 21 really unable to reflect economic substance in some circumstances? Or is the above argument merely a temporary complaint from specific regions when exchange rates significantly fluctuate and a minor claim that does not conform to the Conceptual Framework? In short, we do not know for sure yet. This may be so because there are many different arguments about the issue. We believe, however, the more fundamental reason for various arguments is that IAS 21 does not clearly point out what the objective of translation is and thus it is impossible to determine how the resulting foreign exchange gains and losses should be recognised in order to conform to that objective.

6.3 Current IAS 21, without providing sufficient grounds, states that foreign exchange gains and losses of all monetary items resulting from translating transactions involving monetary items are to be recognised in profit or loss for the period, and foreign exchange gains and losses resulting from translation of functional currency financial statements are to be recognised in other comprehensive income.

6.4 Judging from this requirement, IAS 21 seems to view a change in exchange rates as a separate event that occurred to a reporting entity and thus regard that it is appropriate to recognise the foreign exchange gains and losses in profit or loss, i.e., as realised gains and losses, since the effect of a rate change has direct cash flow effects on the monetary item.

6.5 The question of how to appropriately account for foreign exchange gains and losses has been a longstanding issue. Some view foreign exchange gains and losses as period cost since they are costs (or benefits) that occur from possessing monetary foreign currency items before settlement. Others view them as part of borrowing cost and thus as cost adjustment of the original purchase transaction.

6.6 These arguments are no longer discussed, except in the emerging economies experiencing significant exchange rate fluctuations. We believe that this lack of discussion on the issue is because fair value measurement has become a major measurement basis and also it is viewed that much of the accounting mismatch related to foreign currency translation has been solved by introducing hedge accounting and/or borrowing cost basis and fair value option.

6.7 We believe, however, that there is a need to reexamine IAS 21, given that accounting standards associated with foreign currency risk were not examined while there were the changes in accounting standards mentioned as above paragraph. If resolving accounting mismatch is one of the goals pursued by accounting standards, we believe it is natural to reexamine the accounting standards associated with foreign currency risk on the basis of the results of resolving accounting mismatch resulting from foreign currency risk.

6.8 By reexamining the accounting standards associated with foreign currency risk, the objective of recognising foreign exchange gains and losses should be clarified.

6.9 Therefore, in this chapter, we first looked into the existing viewpoints regarding the nature of foreign exchange gains and losses of monetary items, and then sought to find an appropriate alternative for recognising foreign exchange gains and losses of monetary items.

- Point 1: Method of deferring foreign exchange gains and losses of monetary items
- Point 2: Method of treating foreign exchange gain or loss as an adjustment to the cost of imports or the revenue from exports
- Point 3: Method of recognising exchange difference of monetary items depending on the pattern of exchange rate movement

- Point 4: Alternative methods of recognising foreign exchange gain or loss of monetary items

Issues

Point 1: Method of deferring foreign exchange gains and losses of monetary items

Deferral and Amortisation Method[45]

6.10 Deferral and amortisation method is to amortise deferred foreign exchange gains or losses of monetary items over the remaining period until the maturity in a reasonable manner.

6.11 The rationale for this method is that foreign exchange gains and losses are part of cost or benefit until foreign currency denominated monetary items are settled. It means that an effect of foreign exchange change on long term borrowing should be recognised in profit or loss by amortisation over the remaining period until the maturity of the borrowing, and should not be recognised immediately in profit or loss for the period in which the change occurs. This is because an effect of foreign exchange change on long term borrowing is an incremental cost since an entity enters into foreign currency transactions considering differential interest rate and foreign exchange rate between countries. In other words, it is more reasonable to recognise all the related cost including interest cost and foreign exchange change by amortisation over the borrowing period.

6.12 This method was further supported by the argument that fluctuations in exchange rates could have a significant impact on periodic income reported and yet be meaningless if they were to cancel out over the term to maturity of the foreign currency monetary borrowing. Also some argued that recording foreign exchange gains and losses which reflect rates susceptible to frequent random fluctuations distorts meaningful measurement of profit or loss and recording unrealised foreign exchange gains and losses would introduce large fluctuations that might distort the calculation of

[45] Foreign Currency Translation Issues, the Canadian Accounting Standards Board (AcSB)

debt/equity ratios and could cause violations of debt covenants.

6.13 However, the deferral and amortisation method was rejected by the following arguments and these arguments supported the method of immediate recognition in profit or loss.

- Transaction gains or losses might be considered part of the cost of the borrowed funds, but no rational procedure can be prescribed to accrue the total cost at an average effective rate because until the liability is settled that average rate cannot be objectively determined.
- Past rate changes are historical facts and users of financial statements are best served by accounting for the changes as they occur.
- An exchange gains or loss is an increase or decrease in expected (functional currency) cash flows and should be reflected in profit or loss during the period in which the exchange rate changes. This is also consistent with accrual accounting.
- The deferred amounts do not meet the definition of an asset or liability as defined in Conceptual Framework.
- Deferral and amortisation method may cause amounts to be recognised in profit or loss in patterns which run counter to current economic conditions, thereby causing the financial statements to be not representationally faithful.
- Foreign currency liability is exposed to foreign currency risk unlike the liability in functional currency or funding by issuance of shares. Thus it does not show economic difference between funding sources if all the exchange gains or losses are recognised over the future periods rather than recognised in the period in which the exchange rate change occurs.
- It is inappropriate to account for the expected effect of future exchange rate movement on principal and interest in the current period.
- There may be cases where small transaction gain or loss is included in early years and inordinately high transaction gain or loss is included in later years.

6.14 SFAS 52 rejected deferral and amortisation method on account that no rational procedure can be prescribed to accrue the total cost at an average effective rate.[46]

[46] Refer to para. 127, SFAS 52

6.15 In Canadian accounting standards, Section #1650 which was published in 1983 allowed deferral and amortisation method but replaced it with a method of immediate recognition afterwards. In Australian accounting standards, AAS #20 which was published in 1985 adopted deferral and amortisation method but replaced it with a method of immediate recognition except for the case related to qualifying asset.

6.16 Based on the above observations, it can be said that the method of immediate recognition is supported by the fact that a foreign exchange change is a past transaction and recording foreign exchange gains and losses is consistent with accrual accounting as foreign exchange gains and losses represent an increase or decrease in future expected cash flows.

6.17 However, we note that rationales for the method of immediate recognition do not explain why foreign exchange gains and losses should be recognised in profit or loss instead of other comprehensive income.

Revenue Hedge

6.18 Section #1650 published by Canadian accounting standards Board in 1983 allowed revenue hedge: foreign exchange gains and losses arising on translation of the hedged monetary liability at current exchange rates are deferred until settlement of the liability if the future revenue stream should be identified as a hedge of the specific liability and there should be reasonable assurance that the future revenue stream is and will continue to be effective as a hedge. The future revenue stream was translated at the exchange rate in effect on the date the revenue stream was identified as a hedge, and the difference arising due to cash received being translated at the rate in effect on the transaction date would be deferred and offset against the exchange losses or gains relating to the hedged liability.

6.19 However, those who were against revenue hedge accounting argued that financial statements are not representationally faithful since a portion or all of the entity's revenues are translated at exchange rates which do not reflect current economic reality as revenue is translated at the exchange rate in effect when the revenue hedge was designated. Also they pointed out that recognition of foreign exchange losses on the long-term debt is deferred indefinitely as long as the entity can continually renegotiate the debt and continue to justify that a revenue hedge exists.

Point 2: Method of treating foreign exchange gain or loss as an adjustment to the cost of imports or the revenue from exports

One-transaction perspective[47]

6.20 There was a view that a transaction involving purchase or sale of goods or services with the price stated in foreign currency is incomplete until the amount in dollar necessary to liquidate the related payable or receivable is determined. According to this view, an exchange gain or loss related to the transaction should be treated as an adjustment to the cost of imports or the revenue from exports.

6.21 However, this view was also rejected by the following arguments.

- The cost of an imported asset or the reported revenue from an export sale should not be affected by later changes in the related liability or receivable. The exchange exposure in a purchase or sale transaction whose price is denominated in foreign currency stems not from the purchase or sale itself but from a delay in payment or receipt of the amount. That is, no exchange gain or loss can occur if the amount is received as soon as the price is fixed in foreign currency.
- The exchange gain or loss from an exchange exposure is the result of an event (a rate change) that is separate from the original purchase or sale transaction. Since an exchange exposure can usually be eliminated, a determination not to avoid exchange exposure should be accounted for by recognising the gain or loss that results from that decision.

6.22 Based on the above argument, it can be said that current IAS 21 requires exchange gain or loss of monetary items to be recognised in profit or loss since it views exchange gain or loss as a result of an event separate from the original purchase or sale transactions.

[47] Refer to para. 113-115, SFAS 8

6.23 And yet, a different view is taken by other IFRS standards which do not regard exchange gain or loss as a result of an event separate from the original purchase or sale transactions. These standards are IAS 23 ‘Borrowing costs’ and IAS 39, especially related to hedge accounting for foreign currency risk.

6.24 IAS 23 requires that an entity capitalise a part of exchange difference, which is considered as an adjustment to interest cost, related to foreign currency borrowing that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Then which part is considered as an adjustment to interest cost? IAS 23 does not provide detailed descriptions or examples. But as the exchange rate generally reflects the differential interest rates between countries, all of the exchange difference related to foreign currency borrowing would constitute the cost of qualifying asset as an adjustment to interest cost until the qualifying asset is prepared for its intended use or sale.

6.25 We note that capitalising exchange difference means that an exchange rate change is not regarded as a separate event resulting from a management’s decision to defer the receipt or payment of a foreign currency amount. In other words, accounting for the exchange difference in IAS 23 takes one-transaction perspective.

6.26 This report does not intend to discuss whether capitalising exchange difference resulting from acquisition of the qualifying asset is appropriate or not. The issue in here is that while IAS 21 takes two-transaction perspective that recording exchange difference of monetary items in profit or loss is because foreign currency risk of monetary items stems not from the original purchase or sale but from a delay of receipt or payment of foreign currency amount, IAS 23 requires an entity to determine whether the exchange difference of monetary items should be recognised in profit or loss or capitalized as a cost of the qualifying asset at the time of capitalizing the qualifying asset. This leads to confusion about the rationale for recognising exchange difference of monetary items in profit or loss in IAS 21.

6.27 Hedge accounting in IAS 39 does not seem to take two-transaction perspective as IAS 21, either. In IAS 39, non-derivative financial asset or non-derivative financial liability can be designated as hedging instrument. For example, an effective portion of exchange difference of monetary items designated as cash flow hedging instrument is reported as other comprehensive income, and in this case, a hedged item is recognised at the exchange rate on the date of hedge designation and exchange difference resulting from non-derivative financial asset or non-derivative financial liability is reflected in the cost of the imported asset or revenue from exports of the hedged item.

Point 3: Method of recognising exchange difference of monetary items depending on the pattern of exchange rate movement

Current/PPP method

6.28 Ruland (1988) proposed the current/PPP method. Under this method, for monetary items, foreign exchange gain or loss is recognised in profit or loss if the exchange rate movement shows either an upward trend or downward trend (i.e. a change in exchange rate is not likely to reverse), and foreign exchange gain or loss is recognised in equity if the exchange rate fluctuates without showing any upward or downward trend since the gain or loss would not likely to be realised.

6.29 One disadvantage of this method, however, is that determining whether the exchange rate movement shows a trend requires a certain amount of time after the exchange rate movement occurs, which would make it difficult to apply this method in practice.

Other

6.30 A proposal that an exchange gain or loss should be recorded only if the rate changes more than a specified percentage was rejected since even a relatively minor change in rate can sometimes have a material impact on the financial statements, depending on the size of an entity's exposed position in foreign currency. Another view that an exchange gain or loss should be deferred if the rate change that causes the exchange gain or loss is likely to reverse was also rejected on the grounds that it requires distinguishing rate changes that will reverse from those that will not and also requires predicting the changes in an entity's exposure to rate changes between the time of a rate change and the time of its reversal.

Point 4: Alternative methods of recognising foreign exchange gain or loss of monetary items

6.31 IAS 21 does not explain the reasons for recognising foreign exchange gains or losses. IAS 21 merely requires the following: foreign exchange gains or losses of monetary items be recognised in profit or loss for the period regardless of the distinction between current and non-current items; and for nonmonetary items, the effects of exchange rate changes be recognised in other comprehensive income when the corresponding gains or losses are recognised in other comprehensive income, and the effects of exchange rate changes be recognised in profit or loss for the period when the corresponding gains or losses are recognised in profit or loss for the period.

6.32 Then what is the basis for requiring foreign exchange gains or losses of monetary items to be recognised only in profit or loss for the period? Paragraphs 123 and 124 of SFAS 52 state as follows:

> 123. **Transaction gains and losses have direct cash flow effects when foreign-denominated monetary assets or liabilities are settled** in amounts greater or less than the functional currency equivalent of the original transactions.
>
> 124. The Board has concluded that **such gains or losses should be reflected in income when the exchange rates change rather than when the transaction is settled or at some other intermediate date or period. This is consistent with accrual accounting; it results in reporting the effect of a rate change that will have cash flow effects when the event causing the effect takes place.**

6.33 However, if the basis for requiring foreign exchange gains or losses of a monetary item to be recognised in profit or loss for the period is that the effect of a rate change has direct cash flow effects when the monetary item is settled, then it is difficult to understand why foreign exchange gains or losses of a non-current monetary item is required to be recognised in profit or loss. For example, although changes in value for available for sale financial assets is considered as uncertain to be directly reflected in cash flows, a change in foreign exchange rate is recognised in profit or loss.

6.34 Changes in value of available for sale debt instruments may be divided into: changes in value by a loss event; changes in value by other risks excluding foreign currency risk; and changes in value by foreign currency risk. Changes in value by a loss event or foreign currency risk are reflected in profit or loss, and changes in value by other risks excluding foreign currency risk are recognised in other comprehensive income.

6.35 Recognising a part of gains or losses related to changes in value of an available for sale financial asset may be regarded as viewing such gains or losses as already realised. This is because only the realised portion from the part that was recognised as other comprehensive income on disposal is restated in profit or loss, and when a loss event occurs, that is, when realisation of an impairment is certain because its reversal is highly unlikely, the impairment loss is reflected in profit or loss. In view of this, it is obvious that an exchange rate change is deemed as an event that realises profit or loss, such as disposal or impairment.

6.36 However, strict conditions must be met in order to recognise impairment losses, and losses are recognised in other comprehensive income rather than profit or loss when there is a high possibility of reversal and a low possibility of immediate realisation such as temporary decrease in prices or credit ratings.

6.37 Now let us examine an event where a change occurs in exchange rates. The effects of changes in foreign exchange rates for monetary items classified as current items are highly likely to be realised because the corresponding foreign exchange gains or losses have direct cash flow effects when settled. However, the effects of changes in foreign exchange rates for monetary items classified as non-current items have a high possibility of reversal and a low possibility of immediate realisation such as "unrealised loss that is not recognised as a result of loss event." Therefore, in order to deliver useful information to users of financial statements, limitations should be posed to recognition of foreign exchange gains or losses of such items as realised gains or losses, just as the limitations posed to recognition of impairment losses.

6.38 Prior version of IAS 21 allowed selectively recognising an exchange difference as an asset, rather than in profit or loss for the term, the exchange difference occurring from severe currency devaluation or depreciation that affects liabilities having no practical means of hedging, directly related to a recent acquisition of an asset, and that cannot be settled. However, this type of accounting treatment was eliminated to pursue consistency since it is not consistent with the Conceptual Framework and such accounting treatment was not allowed or required by any other country's accounting standards.

6.39 This report does not intend to discuss the validity of IAS 21 prior to amendment. The point here is that the situation referred in IAS 21 prior to amendment is an occurrence of an event, just as a loss event, where foreign exchange gains or losses are recognised as realised gains or losses. We believe that recognising foreign exchange gains or losses of non-current items in profit or loss in the above-mentioned situation would provide users with useful information and be in line with the recognition criteria of impairment.

6.40 However, even if foreign exchange gains or losses are generated by severe currency devaluation or depreciation, it is not appropriate to recognise such gains or losses in profit or loss if the devaluation or depreciation is a rate change with a high possibility of reversal and the gains or losses do not have direct cash flow effects at the time of settlement.

6.41 We note that current/non-current method had already been dismissed in the past. The reason was that determining the measurement basis for assets and liabilities is different from determining the classes of current and non-current, and also that translation is related to measurement, not to classification.[48]

6.42 However, when determining whether foreign exchange gains or losses of monetary items should be recognised in profit or loss or in other comprehensive income, the appropriateness of the method for distinguishing translated items as current items or non-current items (or short term items or long term items) may be considered. This may be so because the basis for the argument that foreign exchange gains or losses should be recognised in profit or loss derives from the perspective that such gains or losses

[48] Refer to para. 129, SFAS 8

have direct cash flow effects at the time of settlement.

6.43 The IASB has not yet provided any conceptual basis regarding which particular items in which particular circumstances should be recognised in other comprehensive income. Furthermore, "Reporting Comprehensive Income" in SFAS 130 does not provide any explanations about this matter either. When both profit or loss and other comprehensive income are presented in the statement of comprehensive income, this may be considered as that there is no conceptual basis as to which items should be classified as an item for profit or loss. However, what is clear is that changes in value of items having an extremely high possibility of realization into cash flows, such as short-term trading items, are not recognised in other comprehensive income.

6.44 Recently, the IASB has increased the number of items that are recognised in other comprehensive income[49] in many areas. IFRS 9, in particular, now requires changes in fair value of equity instruments that are not held for the purpose of short-term trading to be recognised in other comprehensive income, and for financial liabilities designated by fair value option, requires the effects of fair value changes caused by the credit risk of the liabilities to be reflected in other comprehensive income. Such an accounting treatment was established because there is little possibility of realisation into cash flows from fair value changes of equity instruments held for particular purposes as well as the cash flows from credit risk changes of liabilities designated by fair value option. Another reason for establishing such accounting treatment is that even if such changes are presented in other comprehensive income, they still provide useful information to the users of financial statements because the users can identify the fair value changes.

Alternative 1. Recognition of foreign exchange gains or losses of long term monetary items in other comprehensive income

6.45 There are many different bases as to determining whether an item should be recognised in profit or loss or in other comprehensive income. If the possibility of realisation into cash flows is chosen as the basis for such a distinction, we believe the first item to be

[49] Change in revaluation reserve (IAS 16 and IAS 38), actuarial gain or loss (IAS 19), translation adjustment (IAS 21), gain or loss of available-for-sale instrument (IAS 39), effective portion of gain or loss from hedging instrument under cash flow hedge(IAS 39) and etc

recognised in other comprehensive income is foreign exchange gains or losses of non-current items, according to the current IFRSs. The reason is that the possibility of realisation into cash flows from translation of these items is not very high, and thus recognising the foreign exchange gains or losses of non-current items in profit or loss would mislead users, providing them with not very useful information. Below are the reasons why we believe foreign exchange gains or losses of non-current monetary items should be recognised in other comprehensive income.

- Foreign exchange gains or losses of non-current monetary items for each period have a high likelihood of reversal, and because of the nature of non-current items, the effects of rate changes in the corresponding period are less likely to be realised into cash flows in an immediate manner.
- Even if foreign exchange gains or losses of non-current monetary items are recognised in other comprehensive income, this is consistent with accrual basis accounting because the effects of rate changes having cash flow effects are recognised in the same period in which the event that caused the change occurred.
- Paragraphs 15, 32, and 33 in IAS 21 state that, out of the monetary items to be received from or paid to a foreign operation, valuation gains or losses of items that are not planned for and having a low possibility of settlement in the foreseeable future are recognised in other comprehensive income when preparing consolidated financial statements and reclassified from asset to profit or loss when sold. This is consistent with recognising foreign exchange gains or losses of non-current monetary items in other comprehensive income.
- Realised gains or losses and unrealised gains or losses are different from each other. Therefore, presenting them separately in the “statement of profit or loss and other comprehensive income” would provide more useful information to users of financial statements.
- Recognising foreign exchange gains or losses of non-current monetary items in other comprehensive income is in line with IFRS 9 which requires changes in fair value of equity instruments that are not held for the purpose of short-term trading to be recognised in other comprehensive income, and for financial liabilities designated by fair value option, requires the effects of fair value changes caused by the credit risk of the liabilities to be reflected in other comprehensive income.

6.46 However, classifying foreign exchange gains or losses into profit or loss or other comprehensive income based on the possibility of realisation into cash flows would leave a question of whether to recycle the foreign exchange gains or losses recognised in other comprehensive come. That is, if recycling is necessary, interpretations in terms of accounting concepts should be provided regarding when it should be performed and what the economic significance is when the foreign exchange gains or losses recognised in other comprehensive income are recognised in profit or loss at once at the time of recycling. If recycling is prohibited, only the effects of rate changes after reclassified into the category of current item is made would be reflected in profit or loss. We believe that there should be further discussions regarding the validity of this method and whether separately recognising in other comprehensive income and profit or loss causes any complexity.

Alternative 2. Recognition of exchange differences of all monetary items in other comprehensive income

6.47 We may consider a method that recognises exchange differences of all monetary items in other comprehensive income without recycling. The basis of this method is that since rate changes have a high possibility of reversal and thus are less likely to be realised into cash flows, they are recognised in other comprehensive income until disposal and not recycled or re-recognised in profit or loss because gain or loss have already been recognised once in other comprehensive income.

6.48 The main advantage of this method is that it does not require recycling and it reduces fluctuation of profit or loss. However, this method also recognises exchange differences of monetary items distinguished as short-term trading items in other comprehensive income, and thus there should be explanations as to why the exchange differences of short-term trading items are determined as less likely to be realised into cash flows. Furthermore, there should also be explanations in terms of the concept of other comprehensive income about why changes in value of short-term trading items caused by other than foreign currency risk are recognised in profit or loss when changes in value caused by foreign currency risk are recognised in other comprehensive income.

Summary

6.49 This chapter examined the past discussions about the methods for recognising foreign currency translation gains or losses, the method for recognising foreign exchange gains or losses of non-current monetary items in other comprehensive income, as well as the alternative method for recognising exchange differences of monetary items in other comprehensive income.

6.50 As pointed out above, current IAS 21 merely states that all foreign exchange gains or losses resulting from translating monetary items in a foreign currency transaction are recognised in profit or loss, and foreign exchange gains and losses resulting from translation of functional currency financial statements are recognised in other comprehensive income, without providing the grounds.

6.51 In order to find an appropriate method for recognising foreign currency translation gains or losses, we believe the objective of translation should be established above all and then a corresponding recognition method should follow.

6.52 This chapter reviewed whether foreign exchange gains or losses should be recognised in profit or loss or in other comprehensive income based on the distinction between current items and non-current items. This approach is consistent with accrual basis accounting because the effects of rate changes having cash flow effects are recognised in the same period in which the causative event occurred. Furthermore, by recognising foreign exchange gains or losses of non-current items having a high possibility of reversal and a low possibility of immediate realisation in other comprehensive income, fluctuation of profit or loss may be reduced.

6.53 However, additional reviews should be conducted to determine if and when foreign exchange gains or losses of non-current items recognised in other comprehensive income should be recycled.

6.54 The alternative that does not recycle after recognising foreign exchange gains or losses of monetary items in other comprehensive income may be able to reduce complexity. However, in the absence of any conceptual definition for other comprehensive income, this method recognises foreign exchange gains or losses of short-term trading items in other comprehensive income even though the items have a high likelihood of immediate realization into cash flows. Therefore, conceptual definition of other comprehensive income should precede.

VII. Linked Presentation

Background

7.1 Emerging economies are highly dependent on external factors and thus entities in emerging economies have been greatly affected in terms of their finance every time exchange rates fluctuated. Consequently, entities in these emerging economies have engaged in hedging activities in order to hedge the foreign currency risk they are exposed to, and applied hedge accounting to reflect such activities in their financial statements.

7.2 The objective of hedge accounting is to reflect hedging activities in the financial statements and thus help users of the financial statements to understand how the management of an entity deals with the risks the entity faces as well as the resulting financial consequences. Therefore, an entity that desires to hedge foreign currency risk carries a responsibility to report the kind of hedging strategy it is using and the result of applying hedge accounting including the financial consequences thereof.

7.3 Despite such objective of hedge accounting, however, there is growing concern that the presentation method of the current fair value hedge accounting may not be able to appropriately show economic substance of the hedging strategy and financial consequences of an entity that engages in hedging activities to hedge foreign currency risk.

7.4 This criticism was raised in particular by the shipbuilding industry, which is most conspicuously affected by this issue. Shipbuilding companies enter into large-scaled, long-term firm commitments denominated in foreign currency and hedge the foreign currency risk of these firm commitments.

7.5 Having many large-scaled, long-term contracts denominated in foreign currency, shipbuilding companies generally enter into large-scaled foreign currency forward contracts and apply fair value hedge accounting in order to hedge foreign currency risk of firm commitments. Consequently, when exchange rates fluctuate, there is no change in these shipbuilding companies’ economic substance because they have already hedged foreign currency risk. However, the current presentation method may mislead users of financial statements because large amounts of firm commitment assets and foreign currency forward liabilities are required to be recognised in gross amounts in the financial statements, causing significant fluctuations in totals of assets and liabilities and also adversely affecting one of the major financial ratios, the debt-to-equity ratio (i.e., liabilities/assets).

7.6 To solve this problem, the KASB and Korea Shipbuilders' Association (KOSHIPA) have continued to assert that, for fair value hedge accounting, linked presentation shows the real economic substance of an entity's hedging activity. Nevertheless, the IASB tentatively decided not to allow linked presentation when they amended the standard associated with hedge accounting.

7.7 Hedge accounting is one of the most difficult accounting fields for financial statement users to understand. Even for professional accountants who have clear concepts and understanding of accounting, hedge accounting is one of the most challenging standards to understand and apply. Given this, imagine how the users of financial statements would feel about hedge accounting. Would they be able to understand that the significant fluctuations in totals of assets and liabilities and the debt-to-equity ratio result from hedge accounting, and risks are actually hedged because the entity is engaged in hedging activities?

7.8 It is true that the current gross presentation method has many advantages. However, the gross presentation method falls short of faithfully representing in the financial statements how the management is dealing with the risks the entity faces as well as the resulting financial effects in a manner that financial statement users can understand. The gross presentation method is a general method to present general accounting treatment, but general accounting treatments cannot present hedging activities in the financial statements. Therefore, it is difficult to view the gross presentation method as an appropriate method for hedge accounting.

7.9 Linked presentation has already been reviewed many times in other projects and was concluded as an unacceptable presentation method. However, the case of linked presentation for hedge accounting is different from other projects. There already are many restrictive conditions in its application, and hedge accounting is only allowed when the effectiveness of hedging can be proven. Therefore, it does not seem right to review linked presentation for hedge accounting, which can only be applied with restrictive conditions, in the same manner as the presentation methods in other projects. In this regard, we believe that linked presentation for fair value hedge accounting should be reexamined.

7.10 In this chapter, the following issues are examined.

- Point 1: Why should fair value hedge accounting be presented using linked presentation?
- Point 2: Is it appropriate to apply linked presentation for all fair value hedge accounting?
- Point 3: What is the basis for opposing linked presentation?

Issues

Point 1: Why should fair value hedge accounting be presented using linked presentation?

7.11 The bases for arguing that fair value hedge accounting should be presented using linked presentation are as follows.

- Hedge accounting has been introduced as a special accounting that is different from general accounting treatment to faithfully represent hedging activities of a reporting entity. However, the current presentation method of fair value hedge accounting requires presenting hedged items and hedging instruments in gross amounts, thereby possibly misleading users of financial statements to overestimate the size of the entity. In other words, although changes in fair values of hedged items and hedging instruments are closely interrelated, the current gross presentation method does not reflect such a property in the financial statements.
- The current presentation method of fair value hedge accounting is mainly focused on presenting the result of hedging activities in the income statement. Consequently, the current presentation method is unable to provide useful information in the statement of financial position about a reporting entity's responsiveness to risks as well as that

helps users to predict the future cash flows of the reporting entity.

- Linked presentation shows exactly the same information as “unlinked” presentation. Furthermore, linked presentation even provides additional information showing that certain assets and liabilities are significantly related. That is, since firm commitments and foreign currency forward contracts have different counterparties from each other and may be realised in different ways from each other, linked presentation shows two sets of information, i.e., net and gross amounts, indicating that the entity’s future cash flows may be expected separately or in a net amount. Therefore, users may choose from the figures shown in the financial statements and use them when calculating totals of assets or liabilities or analyzing financial ratios, depending on their specific purposes.
- Linked presentation explains the fact that derivatives are used for the purpose of hedging activities.

Point 2: Is it appropriate to apply linked presentation for all fair value hedge accounting?

7.12 Some argue that linked presentation for hedge accounting should be applied only to firm commitments in a limited manner. The basis for such arguments is as follows.

- Because firm commitments are generally not recognised as assets or liabilities, the IASB had previously required in IAS 39 to apply cash flow hedge accounting in order to avoid recognising firm commitments as assets or liabilities. Also, the part of the cost of the firm commitment is recognised as the result of another transaction or event, and this event is the same event that incurs changes in fair value of the derivative.
- It is difficult to understand the argument that, since each of firm commitments and currency forward contracts still has credit risk, the risks should always be separately considered when calculating totals of assets and liabilities and these figures should be used when analyzing ratios. The reason is as follows. A firm commitment is recognised in the financial statements as an asset or liability only when fair value hedge accounting is applied. Therefore, if the credit risk of the firm commitment is significant and thus the recognised amount should be used in calculating the totals of assets or liabilities or in analyzing ratios, the firm commitment should have been recognised regardless of applying hedge accounting in the first place. Furthermore,

when a firm commitment's currency risk is hedged, the amount of the firm commitment recognised as asset or liability is not reflecting its credit risk.

Point 3: What is the basis for opposing linked presentation?

7.13 The IASB, on the other hand, did not allow applying linked presentation for fair value hedge accounting based on the following grounds.

- While linked presentation does provide some useful information about the special relationship between certain assets and liabilities, linked presentation is unable to differentiate between the types of risks hedged by the relationship and those that are not. Although the relationship affects only one of several risks underlying the asset or liability (i.e., currency risk), the net amount of the linked asset and liability is presented in the financial statements.
- Linked presentation would not result in more appropriate totals of assets and liabilities for ratio analysis because the hedging affected only one risk but not all risks.
- Disclosures about hedging would be a better alternative to provide financial information for ratio analysis.

Summary

7.14 Hedge accounting was introduced because it was impossible to reflect hedging activities using general accounting treatments. The current gross presentation method is a method to present general accounting treatments. Then would the current gross presentation method be able to appropriately present hedge accounting?

7.15 It is true that the current gross presentation method has many advantages. However, we believe that another method that better serves its purpose, such as linked presentation, should be examined in order to more appropriately present hedge accounting.

VIII. Miscellaneous

Convergence between IFRSs and U.S. GAAP

Recognition of foreign exchange gain or loss of available for sale financial instruments

8.1 While, available for sale debt instruments denominated in foreign currency are viewed as monetary items and thus their foreign exchange gains or losses are required to be recognised in profit and loss for the period[50] in IFRSs, foreign exchange gains or losses of these items are required to be recognised in other comprehensive income in U.S. GAAP[51]. U.S. GAAP views a change in exchange rate as a component of a change in fair value, and thus requires the change in exchange rate to be recognised in other comprehensive income along with other fair value components.

8.2 This issue many no longer be relevant in practice because available for sale category is to be eliminated as IAS 39 is replaced by IFRS 9. However, there still exists a need to examine this issue in relation to the topic of distinction of monetary/nonmonetary items in Chapter IV.

Accounting treatment in hyperinflationary economies

8.3 There is a difference between IFRSs and U.S. GAAP regarding the method for translating functional currency into presentation currency when functional currency is the currency in hyperinflationary economies.

8.4 In IFRSs, namely IAS 29, the financial statements of an entity whose functional currency is the currency of a hyperinflationary economy are stated in terms of the measuring unit current at the end of the reporting period. In other words, nonmonetary items measured at cost or amortised cost are restated applying changes in the general level of prices during the period from acquisition date to reporting date. On the other hand, US GAAP requires the financial statements of such an entity to be remeasured as if the functional currency were the reporting currency.

[50] Refer to para. E 3.2-3.4, IAS 39
[51] Refer to EITF 96-15

8.5 SFAS 52 explains that the Board proposed, in the revised Exposure Draft, that the financial statements be restated to reflect changes in the general price level, but many respondents objected to the revision.[52] It also explains that the current restatement method was adopted as many respondents supported for it. On the other hand, the basis for conclusion in IAS 29 does not describe what was discussed when IAS 29 was issued.

Consistency across IFRSs

Definition of foreign currency risk

8.6 As described in paragraph 2.29, foreign currency risk in IFRSs is defined as "the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates." Also, paragraph 2.32 describes that monetary non-financial instruments such as executory contracts exist. In IAS 39, however, such executory contracts (firm commitments) are viewed as being exposed to foreign currency risk because they may also be designated as hedged items. Therefore, there is inconsistency between the definition of foreign currency risk in IFRS 7 and the items subject to foreign currency hedging in IAS 39.

8.7 IAS 21 requires all exchange differences resulting from monetary items to be reflected in profit or loss, while allowing an exception where exchange differences of monetary items which are part of the net investment to a foreign operation are recognised in other comprehensive income in consolidated financial statements of a reporting entity including the foreign operation.[53]

8.8 However, there are some exceptions in other standards that IAS 21 did not mention. In 'Borrowing Costs' in IAS 23, it is stated that a portion that is regarded as an adjustment to interest expense related to a foreign currency borrowing may be capitalized, and thus this is an exception according to IAS 21. Furthermore, in IFRIC 1, when changes in the measurement of restoration-related provision result from changes in the estimated

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[52] Refer to para. 102-109, SFAS 52
[53] Refer to para. 32, IAS 21

timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, the amounts of the asset and provision are to be adjusted. According to paragraph 16 in IAS 21, a provision repaid in cash is a monetary item. Therefore, according to IAS 21, exchange difference in IFRIC 1 should also be recognised immediately when a change occurs in measurement of a provision.

Accounting for foreign currency risk in hedge accounting

8.9 IAS 39, regarding hedge accounting, prescribes that changes in exchange rate be accounted for in accordance with IAS 39 when applying fair value hedge accounting to hedge foreign currency risk. However, when hedge accounting is not applied to an identical foreign currency item (e.g., foreign currency loan), changes in exchange rates of the item are to be accounted for in accordance with IAS 21. Therefore, even if there is no accounting difference in practice, it would be appropriate to have consistency across the standards.

Review of Alternative Exchange Rates

8.10 The KASB reviewed foreign currency accounting from an economic point of view through outsourced research,[54] and the result showed that when exchange rates fluctuate significantly in an unusual foreign currency market situation, a moving average exchange rate may be applied instead of a nominal exchange rate as of the balance sheet date, thereby limiting temporary and transitional changes embedded in the nominal exchange rate as well as allowing the entity to report its foreign currency related activities in a more realistic manner, which is more true to economic substance.

8.11 This conclusion would have to be based on the premise that it is possible to distinguish whether the exchange rate market is in its usual situation or not. Issues may possibly be raised about the reliability or availability of exchange rates other than the current rate. However, the same kind of issues may be raised regarding the standards associated with translation of presentation currency in hyperinflationary economies. Determining an economy as hyperinflationary is a subjective decision, and there may be issues

[54] Choi, K.H. and B.C. Shin, 'Basic research for improvement of foreign currency translation', Korea Accounting Institute, 2010

regarding the availability of price indexes in such an environment.

8.12 Therefore, it may be possible to consider applying alternative rates if there is a general consensus about the fact that the current rate may not appropriately reflect the economic substance in some situations.

Practical issues raised by the Working Group

8.13 A number of practical issues were raised while carrying out the activities of the Working Group. In addition to some of these issues that were discussed above, there are issues such as the following. (Please refer to Appendix 3 for details)

Issue 1: Guidelines for using average exchange rate

Although the exchange rate at the transaction date is required to be used for foreign currency transactions at initial recognition, an average exchange rate may also be used. We believe, however, it would be useful to have additional guidelines for the use of average exchange rate. For example, additional guidelines should be provided regarding a general method for calculating an average exchange rate (i.e., whether to use an exchange rate from the middle of the period or an average exchange rate between the beginning and end of the reporting period) or determining periods for average exchange rates.

Issue 2: Guidelines for multiple exchange rates or cases where currency exchange is temporarily unavailable

For translation of foreign currency transactions, there are accounting treatments specified for using a number of different exchange rates or cases where exchange between two currencies is temporarily unavailable. However, there is no such accounting treatment specified for translation of functional currency financial statements, and thus related guidelines should be provided.

Other Practical Issues

Advance receipts and sales denominated in foreign currency

8.14 Unearned revenue arising from a sale denominated in foreign currency is generally translated at historical rate because it would fall under the category of nonmonetary item. However, there is an issue of how to recognise the sale amount at the time of recognising the actual sale. Considering that foreign exchange gains or losses of an advance receipt should not be recognised, the same amount as the advance receipt should be recognised as the sale amount even if the exchange rates at the time of recognising the sale and at the time of recognising the advance receipt are different from each other. However, considering that an amount of a sale should be recognised using the exchange rate at the time of recognising the sale, an exchange gain or loss equivalent to the difference between the sale amount and advance receipt would arise.

8.15 This issue should be discussed in more detail along with the issue of appropriateness of the distinction between the monetary and nonmonetary.

IX. Conclusion

9.1. As mentioned in the introduction of this report, entities have always raised issues regarding foreign currency accounting every time the foreign currency market fluctuated significantly. In order to effectively address this issue, we believe that foreign currency accounting should be thoroughly examined.

9.2. This report covered the discussions carried out to date under basic research into a comprehensive review of IAS 21. In particular, we have focused more upon the topic of 'translation of foreign currency transactions' rather than the topic of 'translation of functional currencies.' Also, we noted that there is a need to examine IAS 21 from a conceptual perspective first in order to carry out the comprehensive review. We thus examined the objective and measurement principles of foreign currency translation.

9.3. By conducting such reviews, we pointed out the areas in which the grounds and concepts of the translation method in IAS 21 should be further clarified, and also provided suggestions to improve IAS 21 where needed.

9.4. However, this report does not provide an in-depth discussion on each topic. Therefore, additional basic research and discussions among stakeholders should follow to develop ways to improve the standard. In order to carry out effective and efficient research on this issue, we suggest that the IASB adopt foreign currency accounting as one of the official research projects and put a sufficient amount of resources into the project.

Appendix 1. Comparison of economic exposure

Exhibit 3. Exposure and Hedging When There are Three States of Nature and a Fixed Amount, FF 1000, Due in the Future

(1) To Show: Exposure is the regression coefficient of the future dollar value of the FF position in a regression of that position on the exchange rate. In this case, exposure must also necessarily be FF 1000.

(2) Definitions:

$P_s^* =$ FF 1000 in each state

$P_s =$ Dollar value of FF 1000 in state s at time-t

$= \$S_sP_s^* = \$1000\ S_s$ in this case.

(3) Regression:

$P = a + bS + e$, where here, $a = \overline{P} - b\overline{S} = 0$;

$b = \mathrm{cov}(P,S)/\mathrm{Var}(S)$;

$p_s =$ Probability of state s;

$\overline{P} = \Sigma_s p_s S_s P_s^* = \$1000\ \overline{S} = \$225$ below, since

$\overline{S} = \Sigma_s p_s S_s = 0.225$ \$/FF, from the data.

$\mathrm{cov}(P,S) = \Sigma_s p_s(P_s - \overline{P})(S_s - \overline{S})$

$\mathrm{var}(S) = \Sigma_s p_s(S_s - \overline{S})^2$

(4) Data:

States	p_s	S_s	P_s	$S_s - \overline{S}$	$P_s - \overline{P}$	$(S_s - \overline{S})^2$	$(P_s - \overline{P})(S_s - \overline{S})$
1	1/3	0.25	\$250	0.025	\$25	0.000625	0.625
2	1/3	0.225	\$225	0	0	0	0
3	1/3	0.20	\$200	−0.025	−\$25	0.000625	0.625

(5) Calculated Regression Coefficient:

$$b = \frac{\mathrm{cov}(P,S)}{\mathrm{var}(S)} = \frac{(2/3)(0.625)}{(2/3)(0.000625)} = \text{FF } 1000$$

Exhibit 4. Exposure Measurement When the French Franc Price is Random

1. Regression Equation $\hat{P} = a + b\hat{S} + \hat{e}$, where $\hat{P} = \hat{S}\hat{P}^*$

2. Data

States	P_s	P_s^*	S_s	P_s
1	1/3	1200	0.25	\$300
2	1/3	978	0.225	\$220
3	1/3	1000	0.200	\$200
Means			0.225	\$240

3. Calculation of the Parameters of the Regression of P on S.

States	$S_s - \overline{S}$	$(S_s - \overline{S})^2$	$(P_s - \overline{P})$	$(P_s - \overline{P})(S_s - \overline{S})$	$(P_s - \overline{P})^2$
1	0.025	0.000625	\$60	1.5	3600
2	0	0	−\$20	0	400
3	−0.025	0.000625	−\$40	1	1600
Means	0	(2/3)(0.000625)	0	(1/3)(1.5) + (1/3)(1)	1867

$$b = \frac{\mathrm{cov}(P,S)}{\mathrm{var}(S)} = \frac{[(1/3)(1.5) + (1/3)(1)]}{(2/3)(0.000625)} = \text{FF } 2000$$

$$a = \overline{P} - b\overline{S} = \$240 - \$(2000)(0.225) = -\$210$$

4. Hedge the Exposure: Sell FF 2000 Forward @ F. Proceeds = \$2000(F − S)

Results	State 1	State 2	State 3
Unhedged Dollar Value	\$300	\$220	\$200
Proceeds of Contract	\$2000(F-0.25)	\$2000(F-0.225)	\$2000(F-0.20)
Value of Hedged Asset	\$(2000F-200)	\$(2000F-230)	\$(2000F-200)

Appendix 2. Comparison of IAS 21, SFAS 52, and SFAS 8 (translation of foreign currency transactions)

IAS 21	At the end of each reporting period: (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 hall be translated using the exchange rates at the date when the fair value as determined. (para 230
SFAS 52	At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate.(para 16) Common nonmonetary balance sheet items and related revenue, expense, gain, and loss accounts that should be remeasured using historical rates in order to produce the same result in terms of the functional currency that would have occurred if those items had been initially recorded in the functional currency (para 48) Inventories- Applying the rule of Cost or Market, whichever is lower, to Remeasure Inventory Not Recorded in the Functional Currency (para 49~para53)
SFAS 8	At each balance sheet date, recorded dollar balances representing cash and amounts owed by or to the enterprise that are denominated in foreign currency shall be adjusted to reflect the current rate. At each balance sheet date, assets carried at market whose current market price is stated in a foreign currency shall be adjusted to the equivalent dollar market price at the balance sheet date (that is, the foreign currency market price at the balance sheet date multiplied by the current rate). (Para 7)

Appendix 3. Practical issues raised by FX working groups

	Guidance on average rates
Relevant paragraph(s)	22 The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with IFRSs. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate. 40 For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example an average rate for the period, is often used to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.
Issue description	IAS 21 allows an average exchange rate to be used when translating from a foreign currency to the functional currency and translating from a functional currency to a presentation currency, if the exchange rates do not fluctuate significantly. However, there is minimal guidance on the determination of such rates. For example, guidance could be provided on: (a) a general methodology (for example, mid-period rate or average of opening and closing rates for the period?); (b) the length of period selected to average the exchange rates; and (c) types of item that the average exchange rate could apply to (for example, whether it is cost effective to monitor average rates for a small number of foreign currency transactions).
Issue 2	**Monetary and non-monetary distinction**
Relevant paragraph(s)	16 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. Examples include: pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; and cash

	dividends that are recognised as a liability. Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, 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. Examples include: amounts prepaid for goods and services (eg prepaid rent); goodwill; intangible assets; inventories; property, plant and equipment; and provisions that are to be settled by the delivery of a non-monetary asset.
Issue description	Even with guidance from paragraph 16 and guidance provided by other standards (e.g. IAS 32 and IAS 39), there will be a number of situations where the distinction may not be clear. Paragraph 16 refers to 'pensions and other employee benefits to be paid in cash' as an example of a monetary item. However, it may be that a defined benefit plan has assets that are denominated in a foreign currency and that these assets may be non-monetary assets. Since IAS 19 *Employee Benefits* requires an employer to measure an asset or liability under a defined benefit plan at 'a current value' at the balance sheet date, then IAS 21 effectively requires such assets to be translated at the closing rate. Exchange differences on monetary items are generally recognised in profit or loss whereas exchange differences on non-monetary items are recognised in profit or loss only when valuation gains and losses are recognised in profit or loss. This potentially results in a mismatch since, under IAS 19, the valuation gains and losses that are actuarial gains and losses that can be either immediately recognised in profit or loss, other comprehensive income or recognised under the 'corridor approach'. IAS 21 does not specify how an employer should account for any exchange differences arising from defined benefit plans.
Issue 3	**Treatment of exchange differences for monetary items**

Relevant paragraph(s)	28 Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32. 32 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 (eg consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment in accordance with paragraph 48.
Issue description	The general rule in IAS 21 is that exchange differences on the settlement or retranslation of monetary items are recognised in profit or loss in the period in which they arise, barring paragraph 32. Paragraph 32 identifies monetary items forming part of an entity's net investment in a foreign operation as an exception to this rule. However, there are other possible exceptions that have not been addressed by IAS 21. (a) Paragraph 6(e) of IAS 23 *Borrowing Costs* allows an entity to capitalise exchange differences arising from foreign currency borrowings to the extent that the differences are regarded as an adjustment to interest costs. (b) One example of a monetary item given by paragraph 16 is 'provisions that are to be settled in cash'. Generally, it will be appropriate for exchange differences arising on provisions to be recognised in profit or loss in the period in which they arise. IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* applies to any decommissioning or similar liability that has been both included as part of an asset and recognised as a liability in accordance

	with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. IFRIC 1 requires, *inter alia*, that any adjustment to such a provision resulting from changes in the estimated outflow of resources embodying economic benefits required to settle the obligation should not be recognised in profit or loss as it occurs, but should be added to or deducted from the cost of the asset to which it relates. Hence, the requirement of IAS 21 to recognise the exchange differences arising on the provision in profit or loss in the period in which they arise conflicts with this requirement in IFRIC 1 and it may not be clear whether exchange differences in this situation should be accounted according to IFRIC 1 or IAS 21.
Issue 4	**Guidance on the event of dual rates or suspension of rates regarding presentation currency**
Relevant paragraph(s)	26 When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.
Issue description	Guidance is provided on the issue of dual rates (where there is more than one exchange rate for that particular currency depending on the nature of the transaction) and suspension of rates (exchangeability between two currencies is temporarily lacking at the transaction date or at the subsequent balance sheet date) in relation to the translation of foreign currency transactions and balances into an entity's functional currency. However, there is no current guidance on this issue in the context of translating the results and financial position of an entity into a different presentation currency.
Issue 5	**Translation of equity items into functional and/or presentation currency**
Relevant	NA

paragraph(s)	
Issue description	IAS 21 is silent on the translation into its functional currency of an equity item denominated in a currency other than the functional currency. For example, entities may issue share capital denominated in a currency that is not its functional currency or, due to changes in circumstance that result in a re-determination of its functional currency, may find that its share capital is no longer denominated in its functional currency. IAS 21 makes only limited reference to the translation of equity items to a presentation currency. Guidance could be provided on the translation of share capital, other equity balances resulting from transactions with equity holders (for example, share premium account) and other equity balances resulting from income and expenses being recognised in other comprehensive income (for example, asset revaluation reserves). In theory, two treatments are possible. The foreign currency equity items could be translated at historical rates of exchange or it could be translated annually at the closing rate. In the latter case, a further question would arise in terms on the treatment of the exchange difference – whether it should be recognised in: (a) profit or loss; or (b) other comprehensive income; or (c) within equity.
Issue 6	**Allocating goodwill to an acquired multinational operation**
Relevant paragraph(s)	47 Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be treated as assets and liabilities of the foreign operation. Thus they shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate in accordance with paragraphs 39 and 42. BC32 The Board was persuaded by the reasons set out in the preceding

	paragraph and decided that goodwill is treated as an asset of the foreign operation and translated at the closing rate. Consequently, goodwill should be allocated to the level of each functional currency of the acquired foreign operation. This means that the level to which goodwill is allocated for foreign currency translation purposes may be different from the level at which the goodwill is tested for impairment. Entities follow the requirements in IAS 36 *Impairment of Assets* to determine the level at which goodwill is tested for impairment.
Issue description	Paragraph 47 seems straightforward for a situation where an entity acquires a single foreign entity. However, where the acquisition is of a multinational operation comprising a number of businesses with different functional currencies, paragraph 47 may be inadequate. The goodwill needs to be allocated to the level of each functional currency of the acquired operation but IAS 21 gives no guidance on how this should be done. Paragraph BC32 acknowledges that the level to which goodwill is allocated for foreign currency translation purposes may be different from the level at which the goodwill is tested for impairment under IAS 36. In many cases, the allocation under IAS 21 will be at a lower level. This will apply not only to the acquisition of a multinational operation but also to the acquisition of a single operation where the goodwill is allocated to a larger cash generating unit under IAS 36 that is made up of businesses with different functional currencies. This presents an issue as neither IAS 21 nor IAS 36 provides guidance on the allocation of a goodwill impairment loss when it relates to a larger cash generating unit made up of businesses with different functional currencies, and the relevant exchange rates have changed since acquisition.
Issue 7	**Deferred trading balances**
Relevant paragraph(s)	15 An entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation, and is accounted

	for in accordance with paragraphs 32 and 33. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.
Issue description	Paragraph 15 requires that trade receivables and trade payables are not monetary items that meet the criteria to be part of the entity's net investment in a foreign operation. However IAS 21 is silent on whether it necessarily precludes deferred trading balances (that is, inter-company accounts of a trading nature where individual transactions are settled but the account's aggregate balance never drops below a specified minimum) from being included. If a minimum amount is permanently deferred, it may be considered appropriate for it to be treated as part of a net investment and an amount of the resulting exchange difference to be deferred in equity. However, some might argue that as each individual transaction included in the overall inter-company balance is settled and replaced by a new transaction, settlement is always contemplated and exchange gains and losses arising on such active accounts would not qualify as part of a net investment.
Issue 8	**Monetary items becoming or ceasing to be part of net investment in a foreign operation**
Relevant paragraph(s)	32 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 (eg consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment in accordance with paragraph 48.

Issue description	Paragraph 32 requires that exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation 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 consolidated financial statements, such exchange differences will be initially recognised in other comprehensive income and 'recycled' to profit or loss on disposal of the net investment. However, there are circumstances where an existing monetary item is designated as part of the net investment in a foreign operation, or is redesignated as not being part of the net investment in a foreign operation. IAS 21 is silent on when this should be regarded as having happened and how the exchange difference on it should be treated. For example, when a parent classifies a loan to a subsidiary as being part of the net investment in the subsidiary, some consider this capital injection should be regarded as having occurred at the time it was decided to redesignate the inter-company account. Consequently, exchange differences arising on the account up to that date should be recognised in profit or loss and exchange differences arising thereafter would be recognised in other comprehensive income on consolidation. Others argue that if the classification occurs part way through a reporting period, it might be more appropriate to regard this capital injection as having occurred at the beginning of the period and treat all of the exchange differences for the period in the same way.
Issue 9	**Presentation of exchange differences in profit or loss**
Relevant paragraph(s)	52 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 in accordance with IFRS 9 and IAS 39; and …
Issue	Although disclosure is required of the amount of exchange differences

description	recognised in profit or loss for the period, IAS 21 does not specify where in the income statement such differences should be presented. Currently, entities might present them under finance costs or allocate exchange differences to the various line items in the income statement.
Issue 10	**Deemed Disposals**
Relevant paragraph(s)	NA
Issue description	A foreign operation may issue additional shares in the form of scrip dividends or a rights issue that are not fully taken up by the parent. The parent's ownership interest in the foreign operation may, therefore, be diluted, giving rise to a deemed disposal. Deemed disposals and whether a resulting profit or loss should arise, are not specifically dealt with in IFRSs, and IAS 21 is silent on the treatment of the cumulative amount of exchange differences attributable to the reduction in the parent's interest arising on the deemed disposal.

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