STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 21 *The Effects of Changes in Foreign Exchange Rates***
Paper topic	Draft Interpretation on Foreign Currency Transactions and Advance Consideration—Sweep issue

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Introduction

1. At the meeting of the IFRS Interpretations Committee ('the Interpretations Committee') in March 2015, the Interpretations Committee reviewed its proposed draft Interpretation of paragraphs 21-22 of IAS 21 *The Effects of Changes in Foreign Exchange Rates*.[1] The proposed draft Interpretation addresses how to determine which exchange rate to use on initial recognition of a foreign currency transaction in circumstances in which the entity receives or pays consideration in advance of the recognition of the asset, expense or income.

2. During the drafting process for the Interpretation, a concern was raised about the interaction of the proposed draft Interpretation and the presentation in profit or loss of exchange differences arising on the related trade receivable or trade payable balances. This paper describes that concern. To address the concern, we recommend that the draft Interpretation should explain in the Basis for Conclusions that it does not address the classification or presentation of exchange differences arising on monetary items in the Statement of Comprehensive Income (and Income Statement, if presented separately). The paper asks if the Interpretations Committee agrees with this recommendation.

[1] See Agenda Papers 2 and 2A and the IFRIC *Update* for the March 2015 meeting of the Interpretations Committee.

Background

3. This section summarises:

   (a) the key proposals in the draft Interpretation; and

   (b) the relevant requirements in IAS 21 about exchange differences arising on monetary items.

Proposed draft Interpretation

4. The proposed draft Interpretation interprets what is meant by 'the date of the transaction' in paragraphs 21–22 of IAS 21 for the purposes of determining which exchange rate to use on the initial recognition of foreign currency transactions. These paragraphs in IAS 21 require that a foreign currency transaction should be recorded, on initial recognition in the functional currency, by applying the spot exchange rate at the date of the transaction. The date of the transaction is the date on which the transaction first qualifies for recognition in accordance with International Financial Reporting Standards (IFRS).

5. The draft Interpretation applies in circumstances in which foreign currency consideration is received or paid in advance of the initial recognition of the related asset, expense or income and that consequently results in the recognition of a prepayment asset or deferred income liability. The Interpretations Committee tentatively decided that the draft Interpretation only applies when the prepayment asset or deferred income liability recognised in respect of the foreign currency transaction is a non-monetary item as defined in IAS 21.

6. The Interpretations Committee tentatively decided that the draft Interpretation should state that the date of the transaction for the purposes of IAS 21 should be the earlier of:

   (a) the date of the initial recognition of the non-monetary prepayment asset or the non-monetary deferred income liability (which will generally be the date of the payment, or receipt, of the advance consideration); and

   (b) the date that the related asset, expense or income (or part of it) is recognised in the financial statements.

Exchange differences arising on monetary items

7. Subsequent to the initial recognition of a foreign currency balance sheet item, paragraphs 28-29 of IAS 21 require that exchange differences arising on the settlement of monetary items or on translating monetary items at the end of the reporting period should be 'recognised in profit or loss in the period in which they arise' (subject to a few specified exceptions).

8. Neither IAS 21 nor IAS 1 *Presentation of Financial Statements* specifies which line item within profit or loss such exchange differences should be presented.

The concern raised

9. We understand that some entities may have a policy of recognising exchange differences on trade receivables or trade payables in the same line item as the related foreign currency transaction is recognised (ie revenue or cost of sales). Such an approach results in revenue or expense that, cumulatively over time, is recognised at the exchange rate at the date that the foreign currency consideration is received or paid (whether in advance or arrears). Supporters of this view note that, because such an approach reflects the cash that is ultimately received or paid on an income statement transaction, it reflects the economics of the transaction and the foreign exchange risk that the entity is exposed to in respect of that foreign currency transaction. In addition they observe that the amount of revenue or expense recognised in profit or loss is not dependent on the date of invoicing.

10. The concern raised is that the proposal in the draft Interpretation as noted in paragraph 6, together with the illustrative examples, may be read as contradictory to such a policy. This is particularly the case when:

    (a) the date of initial recognition of the non-monetary prepayment asset or non-monetary deferred income liability is not the same date as the payment or receipt of any advance consideration (for example when a contract liability is recognised when an amount of consideration is due from a customer in accordance with paragraph 106 of IFRS 15); or

(b) the consideration is paid or received after the recognition of the related expense or revenue.

11. Because the proposed draft Interpretation specifies the exchange rate to use to recognise a foreign currency transaction that is recognised in profit or loss, it could be viewed as implying that exchange differences on the related trade receivable or trade payable should not be recognised in the same line item as the related foreign currency transaction. Accordingly, those who hold this view think that the proposed draft Interpretation is also interpreting paragraph 28 of IAS 21, in that it is implicitly restricting in which line item exchange differences on monetary items should be recognised.

Staff analysis and recommendation

12. The proposed draft Interpretation addresses how to interpret the date of the transaction in paragraph 22 of IAS 21 for the purposes of identifying which exchange rate should be used on the *initial recognition* of a foreign currency transaction. Furthermore, the Interpretations Committee tentatively decided that the draft Interpretation should apply to foreign currency transactions that give rise to the recognition of a non-monetary prepayment asset or non-monetary deferred income liability.

13. We do not think that, in developing the proposed draft Interpretation, the Interpretations Committee intended to address exchange differences arising on the subsequent retranslation of monetary items, nor did it intend to address in which line item such exchange differences should be recognised.

14. We understand that in practice different entities apply different practices in respect of in which line item in profit or loss exchange differences arising on retranslating monetary items are presented. For example, some entities view such exchange differences as more akin to a financing cost or financing income. We also note that the application of IFRS 15 may have further implications because it provides greater guidance about what is recognised as revenue.

15. We think that the issue about in which line item within profit or loss exchange differences on monetary items are presented is a separate issue from that addressed in

the Interpretation. We also think that the proposed draft Interpretation is valid even without addressing this issue, because it addresses which exchange rate to use on *initial recognition* of the foreign currency transaction. In addition, we note that the Interpretations Committee has not, to date, discussed the question of where exchange differences on monetary items should be presented.

16. In response to the concern raised on the proposed draft Interpretation, we recommend that the Basis for Conclusions for the draft Interpretation explains that it does not address in which line item exchange differences arising on the settlement of monetary items or on retranslating monetary items in accordance with paragraphs 28 and 29 of IAS 21 should be classified or presented within profit or loss.

Question for the Interpretations Committee
Does the Interpretations Committee agree to include an explanation in the Basis for Conclusions of the draft Interpretation as proposed in paragraph 16?