IAS 21 – The Effect of Changes in Foreign Exchange Rates

By Mr. Conor Foley, B. Comm., MAcc., ACA, Dip IFR
Examiner: Formation 2 Financial Accounting

This article deals with aspects of IAS 21 – The effect of changes in Foreign Exchange rates.

Introduction

An entity may carry on foreign activities in two ways

- It may have transactions in foreign currencies for example, an Irish company may purchases lawnmowers from the US and they pay for the lawnmowers in US Dollars, or

- It may have foreign operations for example, an Irish company selling fruit may have an operation growing melons and bananas in Brazil.

In addition, an entity may present its financial statements in a foreign currency i.e. an company based in Ireland (euro) which transacts all its business with the United Kingdom in sterling may decide to present its financial statements in sterling particularly if the Irish company is looking for a UK investor as the potential investor would understand the financial statements denominated in sterling easier than if they were presented in euro.

The objective of IAS 21 is to inform us how to correctly account for foreign currency transactions and foreign operations in the financial statements of an entity as well as how to translate financial statements into a presentation currency. In this article, we will focus on using the standard to correctly account for foreign currency transactions.

Functional Currency

This is the currency of the primary economic environment in which the entity operates i.e. a company based in Dublin and selling all its products in euros in Ireland will have a functional currency of Euro.

The factors involved in determining a functional currency are as follows;

- a) The currency;
  - i) That mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and
  - ii) Of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

- b) The currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Other factors which may also provide evidence of an entity's functional currency include;

- a) The currency in which funds from financing activities are generated;
- b) The currency in which receipts from operating activities are usually retained.

Measurement at recognition

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity;

- a) Buys or sells goods or services whose price is denominated in a foreign currency;
- b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
- c) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency

Initial recognition of a foreign currency transaction shall be recorded by applying to the foreign currency amount the ***spot exchange rate*** between the functional currency and the foreign currency at the date of the transaction.

Example

Moola Limited business is the purchase and selling of tractors. They purchase tractors from the United Kingdom. On the 10th July 2012, Moola Limited purchased five tractors costing £20,000 each. The spot exchange rate on that date was that £1 sterling equals €1.25 euro. Moola Limited functional currency is the Euro.

Required: **Show the journal entry (ignore inventory transactions) required to include the above transaction in the financial statements of Moola Limited.**

Solution

Initially, we need to calculate the total amount owing in sterling and convert that sterling amount into euro i.e. £20,000 x 5 = £100,000 sterling. The spot exchange rate is that £1 sterling equals €1.25 euro. Therefore, the £100,000 sterling equates to €125,000 i.e. 100,000 x 1.25. The journal entry is as follows:

Dr.	Purchases – Cost of Sales – P/L - SOCI	€125,000	
Cr.	Trade Payables – Current Liabilities - SOFP		€125,000

Measurement at the end of the reporting period

At the end of the reporting period;

- a) Foreign currency monetary items shall be translated using the closing exchange 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 shall be translated using the exchange rates at the date when the fair value was determined.

Therefore, in relation to a), items like bank and cash will be translated using the closing exchange rate which for most entities would be the 31st December. Under b), non-current assets like property, plant and equipment which were valued at historical cost will use the exchange rate at the date of the transaction and therefore, in essence there will be no exchange difference arising as the rate applied will not change. In essence, non-monetary items at the end of a reporting period are not revalued as there is no change in the exchange rate and monetary items are revalued.

Exchange Differences

Monetary items therefore, can give rise to an exchange difference. IAS 21 states that an exchange difference is the difference resulting from translating a given number of units of one currency into another currency at difference exchange rates.

Exchange differences are taken to ***profit or loss*** in the period in which they arise.

Example

Kambina Limited entered into the following foreign currency transaction.

30.11.2011 Purchased goods from South Africa amounting to ZAR 1,000,000.

The relevant exchange rates are as follows:

	South African Rand ZAR to Euro €
30.11.2011	10
31.12.2011	8

Required: Record the above transactions in the books of Kambina Limited for the years ended 31st December 2011.

Solution

The accounting treatment for the transactions for the year-ending 31st December 2011 is as follows:

30.11.2011	Dr.	Purchases – P/L – SOCI	€100,000 (ZAR 1,000,000/10)	
	Cr.	Trade Payables – Current Liabilities – SOFP		€100,000
31.12.2011	Dr.	Expense – P/L – SOCI	€ 25,000	
	Cr.	Trade Payables – Current Liabilities – SOFP		€ 25,000

The €25,000 is an exchange difference that arises due to the change in the exchange rates from the 30.11.2011 to the 31.12.2011 i.e. ZAR 1,000,000/8 = €125,000. The difference between €100,000 and €125,000 is €25,000.

Example

Rooella Limited imports marquees from the UK. It had the following transactions with their UK counterpart;

30.09.2010 Purchased goods amounting to Sterling £80,000.
31.03.2011 Paid for the goods

The relevant exchange rates are as follows:

	1 Euro € equals in British Pound £
30.09.2010	1.20
31.12.2010	1.25
31.03.2011	1.00

Required: Record the above transactions in the books of Rooella Limited for the years ended 31st December 2010 and 31st December 2011.

Solution

The accounting treatment for the transactions for the year-ending 31st December 2010 and 2011 is as follows:

30.09.2010	Dr. Purchases – P/L – SOCI	€66,667 (£80,000/1.20)	
	Cr. Trade Payables – Current Liabilities – SOFP	€66,667	
31.12.2010	Dr. Trade Payables – Current Liabilities – SOFP	€ 2,667	
	Cr. Expense – P/L – SOCI		€ 2,667

The €2,667 is an exchange difference that arises due to the change in the exchange rates from the 30.09.2010 to the 31.12.2010 i.e. £80,000/1.25 = €64,000. The difference between €66,667 and €64,000 is €2,667.

31.03.2011	Dr. Trade Payables – Current Liabilities – SOFP	€66,667	
	Dr. Expense – P/L – SOCI	€13,333	
	Cr. Bank – Current Assets – SOFP		€80,000
			(£80,000/1.00)