

DEMYSTIFYING FOREIGN CURRENCY ISSUES



Dealing with foreign currency matters in financial statements often causes difficulty among preparers of financial reports. In this article, we address some common issues on the treatment of foreign currency matters.

FOREIGN CURRENCY TRANSACTIONS

Where an entity has the same functional currency – the currency in which it conducts its operations – and presentation currency – the currency in which it presents financial statements – the only foreign currency matter to consider is the treatment of transactions which happen in a currency different to its functional currency.

The steps required under AASB 121 *The Effects of Changes in Foreign Exchange Rates* are straightforward:

- At the date of the transaction, recognise the transaction in the accounting records at the spot rate on that date
- In subsequent reporting periods:
 - Retranslate any monetary items (including financial assets and liabilities), at the closing rate at the reporting date
 - Do not retranslate non-monetary items (including tangible and intangible assets), unless they are held at fair value – *in which case, translate using the exchange rate at the date when the fair value is determined*

Exchange differences on settlement of monetary items, or on retranslation of monetary items at the reporting date, are recognised in profit or loss, with one exception, covered below.

For non-monetary assets held under a revaluation model, this means that the revaluation is done first in the foreign currency, and the revalued amount is then converted using the exchange rate at the date of the valuation.

Illustrative example: AusCo Pty Ltd – fixed asset acquisition

During the year end 30 June 2020, AusCo Pty Ltd, with a functional and presentation currency of AUD, acquired equipment from an entity based in Foreignland (which uses the currency Foreign Dollar (F\$)), for F\$500,000.

Relevant exchange rates are as follows:

DATE	1 AUD =
Acquisition – January	F\$ 0.78
Year end 1 – June 2020	F\$ 0.70
Settlement – October	F\$ 0.73
Year end 2 – June 2021	F\$ 0.74

Ignoring any potential tax consequences of the transaction, the double entries to make are as follows:

Impacted Accounts, YE 2020	Acquisition – DR/(CR)	Year end – DR/(CR)	Settlement – DR/(CR)
Plant & Equipment	641,026		
Cash			(684,931)
Trade Payables	(641,026)	(73,260)	714,286
Foreign Exchange gains and losses (P&L)		73,260	(29,355)

The total foreign exchange loss recorded in the P&L is **AUD\$43,905**.

Depreciation is calculated on the asset based on the value capitalised at the acquisition date, on a 5-year straight line basis, assuming a residual value of nil; resulting in a monthly depreciation charge of **AUD\$10,684**.

The asset is of a class held under the revaluation model permitted by AASB 116 Property, Plant and Equipment. At the following year end, 18 months post-purchase, the asset is revalued to its fair value. This is determined to be **F\$550,000**.



The revaluation is performed in F\$, and must then be translated into AUD, using the rate at the date of the revaluation:

Impacted Accounts, YE 20XY	In F\$ – pre-revaluation	Revaluation:	In F\$ – post-valuation
Plant & Equipment	500,000	50,000	550,000
Accumulated Depreciation	(150,000)	150,000	
Carrying value of asset	350,000		550,000
Revaluation gains and losses (OCI / Reserve)		(200,000)	



Impacted Accounts, YE 20XY	Amounts pre-revaluation (AUD)	Revalued carrying amount, at historical FX rate	Journal to record revaluation	Revalued carrying amount, at FX rate at revaluation rate	Journal to record impact of FX on revaluation
Plant & Equipment	641,026	705,128	64,102	743,243	38,115
Accumulated Depreciation	(192,308)		192,308		
Carrying value of asset	448,718	705,128		743,243	
Revaluation gains and losses (OCI / Reserve)			(256,410)		
Foreign Exchange gains and losses (OCI / Reserve)					(38,115)

FOREIGN OPERATIONS

Foreign operations are treated differently. To incorporate the results and financial position of a foreign operation into those of the reporting entity through a consolidation, these items must be reported in the reporting entity's presentation currency.

Translation of accounts into the reporting entity's presentation currency

This involves 3 steps for each entity with stand-alone accounts presented in a currency different to that of the reporting entity:

1. The assets and liabilities for each statement of financial position presented (including comparatives) is translated at the closing rate at the date of that statement of financial position.
2. Income and expenses for each statement of profit or loss and other comprehensive income presented (including comparatives) are translated at the exchange rate existing at the dates of each transaction. In practice, an average rate for the period is often used.
3. All resulting exchange differences are recognised in other comprehensive income.

These exchange differences arise because of the translation of income and expenditure at the average rate, and asset and liabilities at the closing rate; and from translating the opening net assets at a closing rate which differs from the previous closing rate.

Incorporation of results and financial position of a foreign operation with those of the reporting entity

These translated financial statements are then incorporated into the consolidated financial statements by following normal consolidation procedures, including the elimination of intra-group balances and transactions.

Intragroup balances

An intragroup monetary asset or liability, whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability or asset without showing the results of currency fluctuations in the consolidated financial statements.

This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations.

Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference is recognised in profit or loss.

Monetary intragroup balances which are neither planned nor likely to be settled in the foreseeable future

The exception to this rule is in the event of the intragroup balance being a long-term receivable or loan, for which settlement is neither planned nor likely to occur in the foreseeable future. These are, *in substance*, part of the entity's net investment in the foreign operation.

Exchange differences on the translation of a monetary item which is part of a reporting entity's net investment in a foreign operation is recognised in profit or loss in the *separate financial statements of the reporting entity or the individual financial statements of the foreign operation*. In the consolidated financial statements, these exchange differences are recognised initially in other comprehensive income and accumulated in a separate component of equity until the disposal of the foreign operation, at which point they are reclassified to the profit or loss.



Monetary item designated in the functional currency of...	Reporting entity	Foreign operation	Other functional currency
Recognise exchange difference in	Individual financial statements of the foreign operation	Separate financial statements of the reporting entity	Both the individual statements of the foreign operation, and separate financial statements of the reporting entity

In the consolidated financial statements, these same exchange differences are recognised in other comprehensive income.

Acquisition accounting

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 are treated as assets and liabilities of the foreign operation, for foreign exchange purposes. Therefore, they are expressed on initial recognition in the functional currency of the foreign operation, and are translated at the closing rate each reporting period, with the exchange differences recognised in other comprehensive income.

Illustrative example: Teapot Australia Ltd's acquisition of Teacup Foreign Ltd

On the first day of the year ending 30 June 2020, Teapot Australia Ltd (Teapot), with a functional and presentation currency of AUD, acquired 80% of the share capital of the entity Teacup Foreign Ltd (Teacup), an entity based in Foreignland with a functional currency of Foreign Dollar (F\$). The purchase price was F\$12.5m. This transaction represented a business combination in accordance with AASB 3 Business Combinations, in which Teapot acquired control over Teacup.

Relevant exchange rates are as follows:

DATE	1 AUD =
Acquisition date – 1 July 19	F\$ 0.77
Average rate in reporting period	F\$ 0.73
Year end 1 – 30 June 20	F\$ 0.70
Year end 2 – June 2021	F\$ 0.74

Note the illustrative example does not consider any potential tax consequences of the transaction.

On acquisition: Goodwill Recognition

	F \$	FX rate: 1 AUD =	AUD
Consideration paid or payable for investment	12,500,000	\$ 0.77	16,233,766
Non-controlling Interest at date of acquisition: 20%	1,880,000	\$ 0.77	2,441,558
Less: Net assets of Teacup at acquisition date	(9,400,000)	\$ 0.77	(12,207,792)
Share Capital	(2,000,000)		(2,597,403)
Retained Earnings	(2,400,000)		(3,116,883)
Fair value adjustments on acquisition	(5,000,000)		(6,493,506)
Goodwill	4,980,000	\$ 0.77	6,467,532

During the period, Teacup generates profits of **F\$780,000**. Translated at the average rate, this represents profits in AUD of **\$1,068,493**.

At the reporting period, retranslation of goodwill at the closing rate means:

	F \$	FX rate: 1 AUD =	AUD
Goodwill	4,980,000	\$ 0.70	7,114,286

This is a difference of **\$646,753**, representing an exchange gain to be recognised in Other Comprehensive Income.

Note: any impairment arising on the goodwill would be translated at the spot rate at the date of recognition.

By 30 June 2020, the following exchange differences are recognised in Other Comprehensive Income in relation to Teacup:

Acquisition date net assets	AUD
At the opening rate	12,207,792
At the closing rate	(13,428,571)
Difference:	(1,220,779)
Profit for the period	
At the average rate	1,068,493
At the closing rate	(1,114,286)
Difference:	(45,793)
Total foreign exchange gain	(1,266,572)
Non-controlling interest:	(253,314)
Attributable to the parent:	(1,013,257)

For further information, please contact Ralph Martin, National Technical Director, or your local RSM adviser.