

FOREIGN CURRENCY TRANSACTIONS (LECTURE A632 - 18.30 MINUTES)

Many companies enter into foreign currency transactions. Whether they buy or sell goods denoted in foreign currencies or have an overseas branch or group member, transactions in foreign currencies will need to be translated into the currency of the reporting entity in the financial statements.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with foreign currency translation in Section 30 *Foreign Currency Translation* and there are some notable differences between FRS 102 and previous UK GAAP which are outlined in the table below:

Issue	FRS 102	Previous UK GAAP
Functional currency	Functional currency is dealt with in FRS 102 and is the currency of the primary economic environment in which it operates.	No concept of separate functional v presentation currency but instead SSAP 20 had a concept of local currency.
Presentation currency	An entity is free to choose which currency it reports its financial information under.	Previous UK GAAP did not permit the use of a presentation currency which was not the local currency.
Derivative instruments	Forex derivative instruments are brought onto the balance sheet at fair value through profit or loss, although hedge accounting is available subject to meeting certain criteria. If hedge accounting is used, fair value gains/losses are taken to other comprehensive income.	Initial measurement of derivatives was not specified but were usually the same (i.e. at transaction price).

1.1 Scope of FRS 102

Section 30 of FRS 102 (March 2018) applies to:

- (a) foreign currency transactions;
- (b) foreign operations; and
- (c) the translation of an entity's financial statements into a presentation currency.

The term 'presentation currency' is defined in the Glossary to FRS 102 as:

*'The currency in which the **financial statements** are presented.'*

1.2 Functional currency

FRS 102 requires each entity to identify its 'functional currency', which is defined in the Glossary to FRS 102 as:

'The currency of the primary economic environment in which the entity operates.'

FRS 102 Glossary
functional currency

An entity's functional currency is a matter of fact – not a choice. Hence, where there has been a change in functional currency, it follows that there has been a change in the primary economic environment in which the entity operates. The 'primary economic environment' is the environment in which the entity operates and is usually the one in which it primarily generates and spends cash.

As noted later in this section of the notes, it is imperative that an entity correctly identifies its functional currency and there are three primary factors which an entity must consider in determining its functional currency:

'(a) the currency:

- (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for 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; and*

(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).'

FRS 102 para 30.3

The factors above are those which FRS 102 says are the 'most important factors' which an entity must take into account when determining its functional currency. In other words, these are the 'primary' factors.

FRS 102 then goes on to provide some secondary factors which are taken into account when the primary indicators of functional currency (see above) do not provide clear evidence as to the entity's functional currency:

- '(a) the currency in which funds from **financing activities** (issuing debt and equity instruments) are generated; and*
- (b) the currency in which receipts from **operating activities** are usually retained.'*

FRS 102 para 30.4

In practice, the primary indicators will often be sufficient enough and management must ensure that they give priority to the primary indicators.

When the functional currency of a foreign operation is unclear, paragraph 30.5 of FRS 102 provides additional factors which should be considered. The objective of these additional factors is to establish whether the foreign operation's functional currency is the same as that of the reporting entity. The reporting entity, in this context, is the entity that has the foreign operation as its subsidiary, branch, associate or joint venture:

- (a) *Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other **monetary items**, incurs **expenses**, generates **income** and arranges borrowings, all substantially in its local currency.*
- (b) *Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.*
- (c) *Whether **cash flows** from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.*
- (d) *Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.'*

FRS 102 para 30.5
(a) to (d)

Example – Functional currency

Topco Ltd is a company based in the UK whose functional currency is GBP. It has a subsidiary located in Spain (Subco). Subco obtains product from Topco and sells them to its local customers. Invoices are generated from Topco in respect of these sales and the Spanish customers pay Topco directly. Proceeds from any cash sales are also remitted to the company's bank account which Topco's central finance department manages and controls.

The functional currency of Subco is GBP because it is merely operating as an extension (ie a branch) of Topco.

1.3 *Ball Holdings v HMRC*

In *Ball Holdings v HMRC*, the functional currency used to prepare Ball Holdings' statutory financial statements was changed from Sterling to US Dollars. The change resulted in Ball Holdings recognising a large foreign exchange loss which the company claimed against its corporation tax as an allowable expense. HMRC enquired into the tax return and subsequently rejected the claim, stating the entity's functional currency should be Sterling and not US Dollars.

Ball Holdings argued that they had entered into a derivative contract, which subsequently triggered the requirements of previous FRS 23 *The effects of changes in foreign exchange rates*. The First-Tier Tribunal (FTT) had to decide whether the requirements of FRS 23 had been correctly applied when the entity changed its functional currency from Sterling to US Dollars.

The key test in FRS 23 (as is the case in FRS 102, paragraph 30.5(a)) was whether the activities of the foreign operation were being carried out as an extension of the reporting entity, rather than being carried out with a significant degree of **autonomy** (see above).

The fundamentals of the case hinged on the 'autonomy' of Ball Holdings. If Ball Holdings did not have autonomy, its functional currency would have been US Dollars; if it did have autonomy, its functional currency would have been Sterling and no translation loss would have arisen.

The FTT concluded that Ball Holdings had not correctly interpreted FRS 23 and had taken the word 'autonomy' out of context. In the context of FRS 23, 'autonomy' is wide as it is a search for a primary economic environment, whereas Ball Holdings had taken it to be confined to the decision-making powers.

HMRC dismissed the taxpayer's appeal as it concluded the entity had incorrectly interpreted the standard stating that the financial statements must be prepared under UK GAAP. The judge subsequently went on to state that any interpretation of accounting standards does not necessarily mean that the financial statements have been prepared under UK GAAP; particularly where that interpretation is incorrect.

This case highlighted the importance of not only determining functional currency correctly, but also **correctly** interpreting accounting standards. A misinterpretation means that the entity has not applied GAAP and HMRC require financial statements to be prepared under GAAP principles.

1.4 Reporting foreign currency transactions

Broadly, the means by which an entity translates foreign currency transactions is no different than in previous UK GAAP (other than where contracted or forward rates are involved). A summary of the method is as follows:

- Translate foreign currency monetary items using the closing rate.
- Translate non-monetary items which are measured in terms of historical cost in a foreign currency using the exchange rate at the date of the transaction.
- Translate non-monetary items which are measured at fair value in a foreign currency using the exchange rates at the date when the fair value was determined.

Examples of monetary and non-monetary items are shown in the table below:

Monetary	Non-monetary
Cash and bank balances	Intangible assets
Bank loans and overdrafts	Property, plant and equipment
Trade debtors/trade creditors	Goodwill
Specific bad debt provisions	Inventory
Holiday pay accruals	Provisions to be settled by way of a non-monetary asset
Deferred tax assets/liabilities	Shareholders' equity
Finance lease obligations	Deferred income (the cash flow has already taken place hence non-monetary)

Exchange differences

Exchange differences on translation are usually recognised in profit and loss. There is no specific guidance in FRS 102 as to where exchange differences should be recognised within the profit and loss account; some entities choose to recognise them in cost of sales (assuming a Format 1 profit and loss account), whereas others choose to recognise them in administrative expenses. Where an entity decides to present exchange differences in cost of sales rather than administrative expenses, or vice versa, this would constitute a change in accounting policy per Section 10 of FRS 102 *Accounting Policies, Estimates and Errors* and hence the change must be applied retrospectively.

1.5 Foreign exchange derivatives

Under FRS 102, an entity (including a small entity) may have to bring derivative financial instruments onto the balance sheet which arise through forward foreign exchange contracts. A 'derivative' financial instrument is an instrument which 'derives' its value from a change in the value of an underlying asset. Therefore, a foreign exchange derivative will derive a value from changes in the foreign exchange rate.

When a company enters into a forward foreign currency contract, say, one month prior to its year-end to sell foreign currency one month after its year-end, then on the date the contract is entered into the fair value of the contract will usually be nil. Over the next two months, foreign exchange rates are likely to fluctuate and these fluctuations will generate a value for the forward foreign currency contract and it is this value that will be reported on the balance sheet and any changes in that value from one reporting period to the next will be recognised in profit or loss; unless cash flow hedge accounting is being applied in which case gains and losses are reported in other comprehensive income.

Example – Foreign exchange derivative

A company has a year-end of 31 March 2018 and reports under FRS 102. On 1 February 2018, the company sells goods to a customer based in America for \$120,000 and payment is to be received in three months' time (i.e. on 30 April 2018). VAT is ignored for the purposes of this example.

The company enters into a forward foreign currency contract to sell \$120,000 on 30 April 2018 at a contracted rate of \$1.65:£1. Details of the foreign exchange rates are as follows:

Date	Spot	Forward rate to 30.04.18
	\$1:£1	\$1:£1
01.02.2018	1.63	1.65
31.03.2018	1.60	1.62
30.04.2018	1.58	-

Under previous UK GAAP, the company would have normally accounted for this transaction using the contracted rate (i.e. 1.65); although the company could have also chosen not to and used the spot rate at the transaction date.

Step 1 – recognise the debtor at the date of sale (1 February 2018)

The company would have accounted for this transaction using the rate in the contract (1.65) under previous UK GAAP as paragraph 4 of SSAP 20 *Foreign currency translation* allowed this and hence under old UK GAAP, the company would have recognised a debtor of £72,727 (being \$120,000 ÷ 1.65).

FRS 102, paragraph 30.7 requires the foreign currency transaction to be recorded at the spot rate at the date of the transaction, hence under FRS 102 the company will translate the sale at 1.63, hence:

Dr Trade debtors £73,620
Cr Sales £73,620

Being translation of sale at spot rate (\$120,000 ÷ 1.63)

Step 2 – calculate the derivative instrument at 31 March 2018

As the contracted rate cannot be used under FRS 102, a derivative instrument is recognised on the balance sheet, calculated as follows:

	£
\$120,000 at contracted rate of 1.65	72,727
\$120,000 at year-end forward rate of 1.62	<u>74,074</u>
Loss on derivative instrument	1,347

The loss has arisen because of what has happened with the exchange rates. If the company were to sell at the year-end forward rate of 1.62 they would receive £74,074, but as they are selling at a contract rate of 1.65 they would only receive £72,727 and hence a loss has been generated on the contract at the year-end which has to be recognised in the financial statements as follows:

Dr Loss on derivative – profit and loss £1,347
Cr Derivative liability – balance sheet £1,347

Being loss on derivative at year-end

Under SSAP 20 no entries would have been needed had the company accounted for the transaction at the contracted rate.

Step 3 – calculate the foreign exchange gain/loss at the year-end 31 March 2018

The company will have to work out the foreign exchange gain or loss as follows:

	£
\$120,000 at the year-end spot rate (1.60)	75,000
Less original debtor recognised	<u>(73,620)</u>
Foreign exchange gain	1,380

This gain is taken to the profit and loss account as a credit (i.e. Dr Debtors, Cr Profit and loss account).

Step 4 – settlement takes place on 30 April 2018

Calculate the derivative instrument at the settlement date

Calculate the fair value of the derivative instrument at the date of settlement as follows:

	£
\$120,000 at settlement date spot rate 1.58	75,949
\$120,000 at year-end forward rate 1.62	<u>74,074</u>
Loss on derivative at settlement date	1,875

The entries at 30 April 2018 in respect of the derivative instrument are:

Dr Loss on derivative (P&L)	£1,875
Cr Derivative liability – balance sheet	£1,875

Being loss on derivative at fair value

Clear the derivative and the debtor

The company's customer will pay them £72,727 (\$120,000 @ 1.65). The derivative instrument is recognised as a liability of £3,222 (£1,347 + £1,875) and hence the journals are:

Dr Cash at bank	£72,727
Dr Derivative liability – balance sheet	£3,222
Cr Trade debtors	£75,949

Being removal of derivative instrument and settlement of debtor

The derivative liability sitting on the balance sheet prior to clearing after receipt of the payment can be reconciled as follows:

	£
\$120,000 @ settlement date spot rate 1.58	75,949
\$120,000 @ contract rate of 1.65	<u>72,727</u>
Loss on forex contract at 30 April 2018	3,222

The £3,222 loss on the derivative represents the loss that the company has made by taking out the forward foreign currency contract. In other words, the company would have received £3,222 more had they undertaken the transaction using spot rates.

A balance of £949 will be left on the customer's account on the sales ledger which is made up of the £75,000 year-end debtor (see Step 3) less £75,949 (£120,000 ÷ 1.58 – see Step 4). This represents the foreign exchange gain.

A comparison of the above example can be seen as follows:

	SSAP 20	FRS 102
	£	£
<u>Profit and loss account – 31 March 2018</u>		
Turnover	72,727	73,620
Foreign exchange gain	-	1,380
Loss on derivative instrument	-	(1,347)
	<u>72,727</u>	<u>73,653</u>
<u>Balance sheet – 31 March 2018</u>		
Asset - trade debtor	72,727	75,000
Liability - derivative financial instrument	-	(1,347)
	<u>72,727</u>	<u>73,653</u>
<u>Profit and loss account – 30 April 2018</u>		
Turnover	-	-
Foreign exchange gain	-	949

Loss on derivative	-	(1,875)
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	-	(926)

Balance sheet - 30 April 2018

Profit and loss reserves b/f 31.03.18	72,727	73,653
Profit and loss reserves c/f 30.04.18	<u>72,727</u>	<u>72,727</u>

1.6 Presentation currency

Some groups may have several entities, some with a different presentation currency and these entities will need to be translated into a common currency in the group accounts.

Where an entity's functional currency is not the currency of a hyperinflationary economy (hyperinflation is inflation which is out of control), the following procedures are applied in order to translate the entity's results and financial position into a different presentation currency:

- (a) Assets and liabilities for each balance sheet (including comparatives) are translated at the closing rate at the balance sheet date.
- (b) Income and expense for each profit and loss account/statement of comprehensive income is translated at exchange rates at the date of the transactions. For practical reasons, an entity may use an average rate for the period. However, if exchange rates fluctuate significantly, the use of the average rate will be inappropriate.
- (c) All resulting exchange differences are recognised in other comprehensive income.

FRS 102 does not prohibit the retranslation of amounts in respect of share capital and equity reserves. However, in practice, the translation of such equity amounts would be meaningless, because any differences would not be reclassified to profit or loss. A difference in equity pre-translation to equity post-translation would simply mean the difference is merely recognised in another component of equity. Hence, share capital and other components of equity should be translated using historical rates (i.e. the rate at the date each amount of share capital was issued or the date of the transaction for equity reserves, such as the revaluation reserve).

The effect of this is that if share capital has been issued on multiple dates, more than one historical rate will apply in translating share capital into the presentation currency. This would also apply to other components of reserves, such as the revaluation reserve; i.e. if more than one revaluation an asset (or

number of assets) has been done, the rate used will be the rate at the date of each separate revaluation.

When this approach is applied, the balance on retained earnings (profit and loss account reserves) will be a balancing figure due to the retranslation of assets and liabilities at closing rate and other equity items at historical rate. FRS 102 does not contain any requirement to take such differences to a foreign currency reserve to allow for subsequent recycling, unlike IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

Example – Retranslation

The financial statements of US Co are prepared using US Dollars as the functional currency. The parent company is located in the UK and prepares consolidated financial statements using Sterling as its presentation currency. Summary financial statements for Forex Co as at 31 March 2018 (when the exchange rate was £1:\$1.50) are as follows:

	<u>\$'000</u>	<u>Historical rate</u>
Net assets	<u>300</u>	
Equity and reserves		
Share capital issued 1.7.17	20	1.60
Share capital issued 1.10.17	50	1.65
Share capital issued 1.12.17	<u>30</u>	1.70
	100	
Revaluation reserve 1.8.17	40	1.62
Revaluation reserve 31.3.18	<u>20</u>	1.50
	60	
Retained earnings	<u>140</u>	
Equity and reserves	<u>300</u>	

The financial statements are translated into the presentation currency as follows:

<u>\$'000</u>	<u>£'000</u>
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Net assets	<u>300</u>	<u>200</u>	
Equity and reserves			
Share capital issued 1.7.17	20	12.5	
Share capital issued 1.10.17	50	30.3	
Share capital issued 1.12.17	<u>30</u>	<u>17.6</u>	
	100	60.4	
Revaluation reserve 1.8.17	40	24.7	
Revaluation reserve 31.3.18	<u>20</u>	<u>13.3</u>	
	60	38.0	
Retained earnings	<u>140</u>	<u>101.6</u>	(balancing figure)
Equity and reserves	<u>300</u>	<u>200.0</u>	

Assume for the purposes of the above example that opening net assets had been translated into Sterling at a value of £100,000 and profit for the year was \$200,000, translated at an average rate of 1.65 (giving £121,200). The difference of £21,200 is a foreign exchange adjustment which, together with the adjustments above, would go to other comprehensive income.