JMC vLearning

"your virtual learning partner"

Consolidated Financial Statements – Foreign Subsidiaries

Mr. M. Imraz Iqbal

JMC Jayasekera Management Centre (Pvt) Ltd

Pioneers in Professional Education

65/2A, Chittampalam Gardiner Mawatha, Colombo 02 | T: +94 112 430451 | E: info@jmc.lk | F: +94 115 377917

LKAS 21 – The Effects of Changes in Foreign Exchange Rates

1. LKAS 21 definitions

   - Functional currency

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

   - Foreign currency

     A currency other than the functional currency of an entity

   - Presentation currency

     The currency in which the financial statements are presented

2. Determination of functional currency

   Primary factors

   - Currency of the country whose economy determines sale prices of goods and services
   - Currency that influences sales prices (often denomination currency)
   - Currency that influences labour, material, other costs

   Also,

   - Currency in which funds from financing activities are generated
   - Currency in which operating cash receipts are retained

   Additional factors for foreign operations

   Foreign operation is 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.

   - Degree of operational independence from parent
   - Proportion of transactions with parent
   - Influence of cash flows on parent's cash flows
   - Financial autonomy compared with parent

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

LKAS 21 functional currency – Summary

Primary economic environment:

Currency and economy influencing sales prices and operating costs

Primary indicator

Currency in which financing funds are received and operating receipts are retained

Extent of integration with reporting entity (foreign operations only)

Supportin g evidence

Mixed indicators? Use judgement to choose FC that most faithfully presents economic effects of underlying

3. Reporting foreign currency transactions in the functional currency – Initial recognition

- Recognize transaction at the rate at the transaction date
- May use e.g. average rate for week or month as a practical approximation

Average rates not reliable if currency fluctuates significantly

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Reporting foreign currency transactions in the functional currency – Subsequent measurement

Monetary items	Non-monetary items at historical cost	Revalued non-monetary items
Rate at the reporting date	Rate at the date of transaction	Rate at date of valuation

Monetary assets

Items that will be received in a fixed or determinable amount of cash

- Cash
- Cash equivalents
- Debt securities
- Accounts receivable
- Notes receivable

Non-monetary assets

Items that will not be received in a fixed or determinable amount of cash

- Inventory
- Prepaid expenses
- Equity securities
- Investment property
- Property, plant, and equipment
- Intangible assets (e.g. goodwill)

Monetary liabilities

Items that will be paid out in a fixed or determinable amount of cash

- Accounts payable
- Notes payable
- Bonds payable

JMC vLearning
"your virtual learning partner"

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

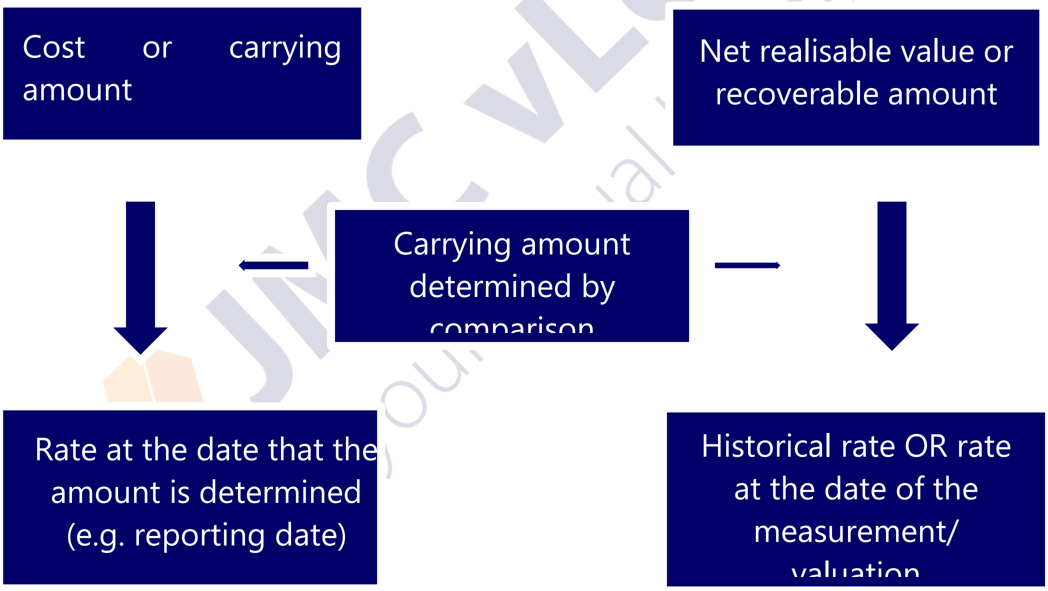
- Leases payable
- Accruals
- Deferred tax (usual classification)

Non-monetary liabilities

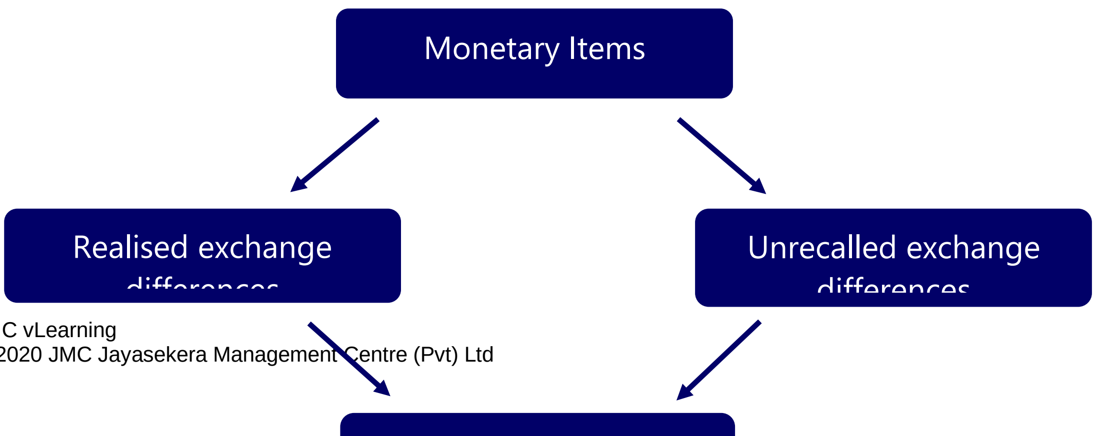
Items that will not be paid out in a fixed or determinable amount of cash

- Deferred income
- Government grant

Reporting foreign currency transactions in the functional currency – "Impaired assets"

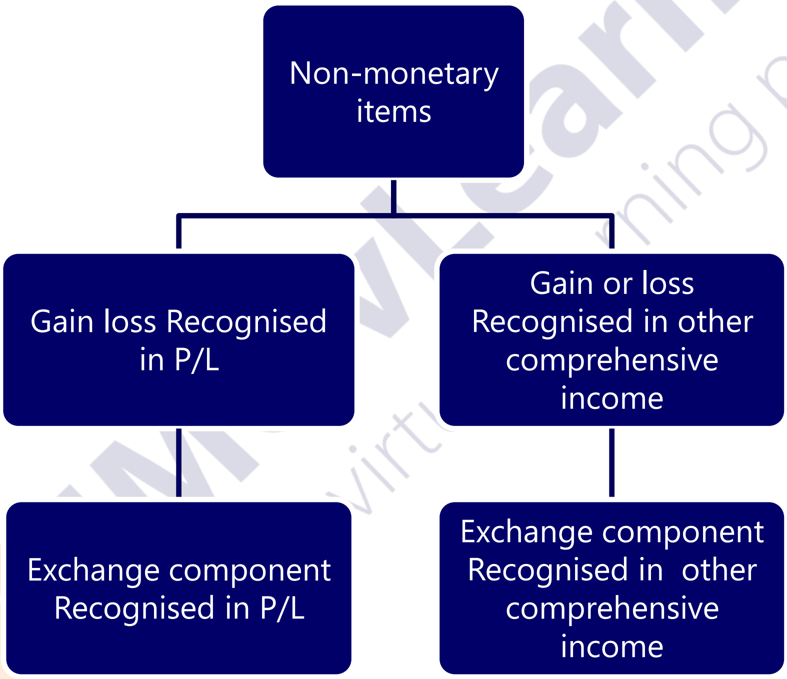


Monetary items – Exchange gains and losses

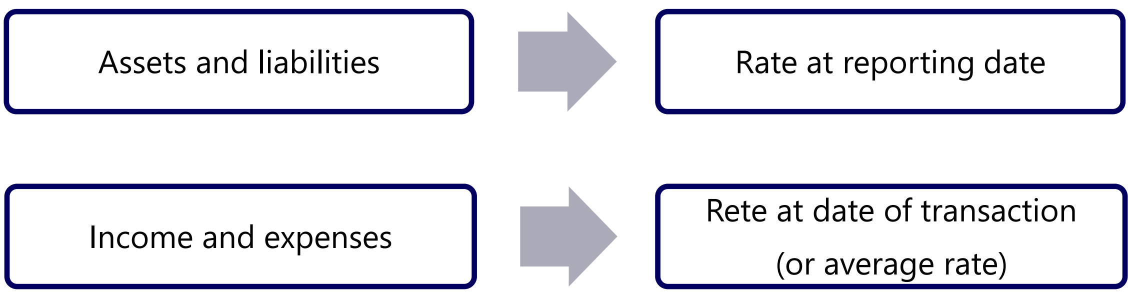


© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Non-monetary items – Exchange gains and losses



Translation to the presentation currency



© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Equity transactions → Rate at date of transaction (oraverage rate)

All resulting exchange c

Explanation of exchange rate difference

- Recalculation of the foreign exchange difference

Opening equity components x CR – Opening equity components x HR

+

Net asset changes from P/L x (CR – HR)

+

Net asset changes from other equity transactions x (CR – HR)

=

Translation adjustment in other comprehensive income

CR = Rate at year end (closing rate)

HR = Historical or average rate

Translation of a foreign operation

- Non-controlling interest allocated share of accumulated exchange difference
- Goodwill and fair value adjustments arising from a business combination are treated as assets/liabilities of the foreign operation translated at the reporting date

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

- Exchange gains and losses on intra-group items are taken to P/L
- Different year-ends
  - 3 month lag permitted
  - Adjust for significant changes between different year-ends

Exchange differences – Net investment in a foreign operation

- Net investment in a foreign operation – the amount of the entity's interest in the net assets of that foreign operation
- If the settlement of monetary item receivable from or payable to a foreign operation is neither planned nor likely to occur in the foreseeable future, exchange differences on such item are recognised:
  - In profit or loss by both the reporting entity and the foreign operation in their individual financial statements
  - In other comprehensive income and accumulated in a separate component of equity in the consolidated financial statements
    - Accumulated exchange differences are reclassified from equity to profit or loss on disposal of the foreign operation

Hyperinflationary economies

What is a hyperinflationary economy?

- No absolute rate at which hyperinflation is deemed to arise. Indicators:
  - Population keeps its wealth in a stable currency or in non-monetary assets
  - Population regards monetary amounts not in local currency but in terms of a stable currency e.g., prices quoted in a stable foreign currency
  - Credit terms compensate for the expected loss of purchasing power during the credit period
  - Interest rates, wages and prices are linked to a price index
  - The cumulative inflation rate over three years is approaching or exceeds 100%
- LKAS 21 does not give a definition of hyperinflation
- Becoming or ceasing to be hyperinflationary is a trend, not a discrete event
- Quantitative factors are not decisive in their own right, but need to be evaluated in the light of the economic circumstance and trends
- Judgement used in coordination with the local profession and local accounting standard setter, so that all companies in a country apply (or cease to apply) LKAS 21 at the same time
- The IFRS Group issues an IS Alert that provides information on which countries are considered to be hyperinflationary under IFRS

JMC vLearning
© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Foreign operations – Hyperinflationary economy

The entity's functional currency is the currency of a hyperinflationary economy

↓

Local FS are restated by inflation index according to IAS 29 Resulting gain/ loss on net monetary position is recorded in P/L

↓

Assets and liabilities, equity items, income and expenses are translated into a different presentation currency

Current year - Closing rate at the date of the most recent recent reporting period presented

Comparatives - Closing rate at the most recent period **only if** presentation currency is a currency of hyperinflationary economy. If not, comparatives should not be restates - i.e. retain the comparatives as they were reported in the previous period.

Recap quiz

- Which of these considerations would not be relevant in determining the entity's functional currency?
    i. The currency that influences sales prices for goods and services
    ii. The currency that mainly influences labor, material and other costs of providing goods or services
    iii. The most financially stable currency that is frequently used in business transactions
    iv. The currency in which funds from financing activities are generate
- At the reporting date assets and liabilities denominated in a currency other than the entity's functional currency are translated as follows:
    i. Monetary items are translated at the exchange rate at the end of the reporting period
    ii. Non-monetary items carried at fair value are translated at the exchange rate at the end of the reporting period
        - 1 is true, 2 is false
        - 1 is false, 2 is true
        - 1 is true, 2 is true

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

  - 1 is false, 2 is false

- An entity with a seasonal pattern of income and expenditure operates in a country where the exchange rate fluctuates significantly during the year. Which of the following exchange rates would probably be used to translate this entity's income statement for the purposes of preparation of its parent's consolidated financial statements?

  i. Year-end spot rate

  ii. Average exchange rate for the year

  iii. Historical exchange rates on the dates of individual transactions

  iv. Monthly average exchange rates

- The following items may indicate hyperinflation:

  i. Interest rates, wages and prices are linked to a price index

  ii. The cumulative inflation rate over three years exceeds 50%

  iii. Local prices may be stated in a stable currency instead of the local currency

  - 1, 2 and 3 are true
  - 2 and 3 are true, 1 is false
  - 1 and 3 are true, 2 is false
  - 1, 2 and 3 are false

Foreign Currency Transactions

Example 1 – Sales, Purchases and Purchases of PPE

A ltd, a company involved in import and export business had the following transactions on 1st January 2019 on credit basis. All these were due for settlement on the 30th of June 2019 in foreign currency.

i. Sales of USD 1,000 to B Ltd

ii. Purchases of USD 300 from C Ltd

iii. Purchase of Machinery USD 400 from D Ltd

The functional currency of the company is LKR and the year end is 31st March.

The exchange rates were as follows.

	USD/LKR
1-1-2019	100
31-3-2019	120
30-6-2019	150

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

JMC vLearning "your virtual learning partner"

Show how this transaction will be accounted for the years ending 31st March 2019 and 2020 with extracts of the financial statements.

Example 2 – Purchase of property in foreign country

X ltd, a company in Sri Lanka whose functional currency is LKR, purchased a building in a foreign country on 1st January 2014 at a cost of USD 10,000. The building had a useful life of 20 years. The company follows the revaluation model in accounting for buildings and revalues in every 2 years. On 31st December 2016 the building was revalued at USD 10,500 and on 31st December 2018 the value was USD 9,800.

The exchange rates were as follows.

	USD/LKR
1-1-2014	100.00
Average for 2014	110.00
31-12-2014	120.00
Average for 2015	125.00
31-12-2015	130.00
Average for 2016	145.00
31-12-2016	160.00
31-12-2016	160.00
Average for 2017	162.50
31-12-2017	165.00
Average for 2018	172.50
31-12-2018	180.00
Average for 2019	190.00
31-12-2019	200.00

Show how the building will be accounted for in the books of X ltd over the years until 31-12-2019

Example 3 – Foreign Currency loan

S ltd, a company in Sri Lanka whose functional currency is LKR, obtained a loan of USD 1,000 on 1st Jan 2018. The loan was to be repaid in instalments of USD 315.5 over 4 years. The effective interest rate on the loan was 10% p.a.

The exchange rates were as follows.

	USD/LKR

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

1-1-2018	100
Average for 2018	110
31-12-2018	120
Average for 2019	125
31-12-2019	130

Show how the loan will be accounted for in the books of S ltd over the years until 31-12-2019

Example - 4 Basic foreign subsidiary consolidation

Statements of Financial Position of P, S and T are given below as at 31st March 2019

	Rs'000	Rs'000	$'000
Non current assets	P Ltd	S Ltd	T Ltd
PPE	100,000	500,00	600
Investment in S Ltd	60,000	-	-
Investment in T Ltd	30,000	-	-
Current assets	50,000	25,000	200
Total Assets	240,000	75,000	800
Equity and Liabilities			
Stated Capital	120,000	30,000	100
Retained Earnings	60,000	25,000	250
Liabilities	60,000	20,000	450
Total Equity and liabilities	240,000	75,000	800

- On 1-4-2016 P acquired 75% of S when S Ltd's retained earnings stood at Rs.10mn
- On 1-4-2018 P acquired 80% of T.
- During the year ended 31-3-2019 the profits made by each company is as follows
  - P - Rs.10mn
  - S - Rs.6mn
  - T - $ 50,000
- The exchange rates were as follows. (1$= Rs)
  - On 1-4-2018 - Rs.100

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

- On 31-3-2019 - Rs.130
- Average rate during the year – Rs. 120

Prepare the Consolidated Statement of Financial Position of P Ltd Group.

Working 1

Acquisition information summary and Group structure

……………………. Ltd

Statement of Financial Position

As at ………………   (in Rs' …………..)

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Goodwill		
Current assets		
Total assets		
Equity		
Stated Capital		
Retained earnings		
Equity attributable to Parent company shareholders		
Non-Controlling Interest		
Total equity		
Liabilities		
Total equity and liabilities		

(In Rs' ……)

Description	**Goodwill calculation**	**NCI**	**Goodwill calculation**	**NCI**	**Group Retained earnings**	**Foreign currency translation reserve (FCTR)**

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Investment						
+ NCI						
(-) Net Assets						
Good will on acquisition date						
Retained Earnings of Subsidiary – Post acquisition						
Investment						
+ NCI						
(-) Net Assets						
Good will on acquisition date						
Retained Earnings of Subsidiary – Post acquisition						
Retained Earnings of parent – Year end						
Balance at year end						

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Working 3 – Translation of Foreign subsidiary S/F/P

Item	USD'000	Ex. Rate	Rs'000
Property, Plant and Equipment			
Goodwill			
Current assets			
Total assets			
Equity			
Stated Capital			
Retained earnings – Acquisition date			
Acquisition date net assets			
Retained earnings - Post			
Equity before FCTR			
FCTR			
Total equity			
Liabilities			
Total equity and liabilities			

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Example – 5 NCI at Fair Value on acquisition date

Statements of Financial Position of P, S and T are given below as at 31st March 2019

	Rs'000	Rs'000	$'000
Non current assets	P Ltd	S Ltd	T Ltd
PPE	100,000	50,000	600
Investment in S Ltd	60,000	-	-
Investment in T Ltd	30,000	-	-
Current assets	50,000	25,000	200
Total Assets	240,000	75,000	800
Equity and Liabilities			
Stated Capital	120,000	30,000	100
Retained Earnings	60,000	25,000	250
Liabilities	60,000	20,000	450
Total Equity and liabilities	240,000	75,000	800

- On 1-4-2016 P acquired 75% of S when S Ltd's net identifiable assets had a fair value of Rs.45mn. On that date the fair value of NCI was Rs.20mn
- On 1-4-2017 P acquired 80% of T when T's retained earnings were $ 120,000. On that date the fair value of NCI of that company was $75,000 and fair value of net assets was $230,000
- Any differences in fair value of net assets and book value of net assets can be considered as increase in land value.
- During the years the profits made by each company is as follows

Company	Currency	Amount '000		
		2016/17	**2017/18**	**2018/19**
P	Rs	15,000	18,000	20,000
S	Rs	4,000	5,000	6,000
T	$	-	50	80

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

The exchange rates were as follows. (1$= Rs)

- The exchange rates were as follows. (1$= Rs)
- Average rate during the year 2017/18 – Rs. 102
- Average rate during the year 2018/19 – Rs. 114

Prepare the Consolidated Statement of Financial Position of P Ltd Group

Working 1

Acquisition information summary and Group structure

…………………… Ltd

Statement of Financial Position

As at ……………… (in Rs' …………..)

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Goodwill		
Current assets		
Total assets		
Equity		
Stated Capital		
Retained earnings		
Equity attributable to Parent company shareholders		
Non-Controlling Interest		
Total equity		
Liabilities		
Total equity and liabilities		

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Description	Good will calculation	NCI	Goodwill calculation	NCI	Group Retained earnings	Foreign currency translation reserve (FCTR)
Investment						
+ NCI						
(-) Net Assets						
Good will on acquisition date						
Retained Earnings of Subsidiary – Post acquisition						
Investment						
+ NCI						
(-) Net Assets						
Good will on acquisition date						
Retained Earnings of Subsidiary – Post acquisition						

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Retained Earnings of parent – Year end						
Balance at year end						

Working 3 – Translation of Foreign subsidiary S/F/P

Item	USD'000	Ex. Rate	Rs'000
Property, Plant and Equipment			
Goodwill			
Current assets			
Total assets			
Equity			
Stated Capital			
Retained earnings – Acquisition date			
Acquisition date net assets			
Retained earnings - Post			
Equity before FCTR			
FCTR			
Total equity			
Liabilities			

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Total equity and liabilities			

Example - 6 Practice question

Rose, a public limited company, operates in the mining sector. The draft statements of financial position are as follows, at 31 March 2019

	Rose Rs' mn	Stem Dinars' mn
Assets:		
Non-current assets		
Property, plant and equipment	483	380
Investments in subsidiaries		
Stem	46	
Financial assets	15	50
	544	430
Current assets	118	330
Total assets	662	760
Equity and liabilities		
Share capital	158	200
Retained earnings	256	300
Other components of equity	7	-
Total equity	421	500
Non-current liabilities	56	160

JMC vLearning "your virtual learning partner"

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Current liabilities	185	100
Total liabilities	241	260
Total equity and liabilities	662	760

The following information is relevant to the preparation of the group financial statements:

1. Rose acquired 52% of the ordinary shares of Stem on 1 April 2018 when Stem's retained earnings were

   220 million dinars. The fair value of the identifiable net assets of Stem on 1 April 2018 was 495 million dinars.

   The excess of the fair value over the net assets of Stem is due to an increase in the value of land. The fair value of the non-controlling interest in Stem at 1 April 2018 was 250 million dinars.

   Stem is located in a foreign country and operates a mine. The income of Stem is denominated and settled in dinars. The output of the mine is routinely traded in dinars and its price is determined initially by local supply and demand. Stem pays 40% of its costs and expenses in dollars with the remainder being incurred locally and settled in dinars. Stem's management has a considerable degree of authority and autonomy in carrying out the operations of Stem and is not dependent upon group companies for finance.

   Rose wishes to use the 'full goodwill' method to consolidate the financial statements of Stem. There have been no issues of ordinary shares and no impairment of goodwill since acquisition.

   The following exchange rates are relevant to the preparation of the group financial statements

	Dinars to Rs.
1 April 2018	6
31 March 2019	5
Average for year to 31 March 2019	5-8

2. Rose has a property located in the same country as Stem. The property was acquired on 1 April 2018 and is carried at a cost of 30 million dinars. The property is depreciated over 20 years on the straight-line method. At 31 March 2019, the property was revalued to 35 million dinars. Depreciation has been charged for the year but the revaluation has not been taken into account in the preparation of the financial statements as at 31 March 2019.

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Required

i. Discuss and apply the principles set out in LKAS 21 The Effects of Changes in Foreign Exchange Rates in order to determine the functional currency of Stem.

ii. Prepare a consolidated statement of financial position of the Rose Group at 31 March 2019 showing the exchange difference arising on the translation of Stem's net assets. Ignore deferred taxation

JMC vLearning "your virtual learning partner"

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

ANSWER

i. The functional currency is the currency of the primary economic environment in which the entity operates (LKAS 21). It should be determined at the entity level. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. The following factors should be considered in determining Stem's functional currency

- the currency that mainly influences the determination of the sales prices; and
- the currency of the country whose competitive forces and regulations mainly influences operating costs

The currency that dominates the determination of sales prices will normally be the currency in which the sales prices for goods and services are denominated and settled. LKAS 21 requires entities to consider primary and secondary factors when determining the functional currency. These factors include the degree of autonomy and the independence of financing.

In Stem's case, sale prices are influenced by local demand and supply, and are traded in dinars. Analysis of the revenue stream points to the dinar as being the functional currency. The cost analysis is variable as the expenses are influenced by the dinar and the dollar. Additional factors to be taken into account include consideration of the autonomy of a foreign operation from the reporting entity and the level of transactions between the two. Stem operates with a considerable degree of autonomy both financially and in terms of its management. Consideration is given to whether the foreign operation generates sufficient functional cash flows to meet its cash needs, which in this case Stem does, as it does not depend on the group for finance. Therefore, the functional currency of Stem will be the dinar as the revenue is clearly influenced by the dinar, and although the expenses are mixed, secondary factors point to the fact that the functional currency is different to that of Rose.

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd