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CL-25-1 | Corporate Financial Reporting

Corporate Level (2025 – Curriculum)

- LKAS 21 – The Effects of Changes in Foreign Exchange Rates

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LKAS 21 – The Effects of Changes in Foreign Exchange Rates

1 - Objective

The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

Accordingly, the standard deals with two situations.

1. A single company transacting in a foreign currency.
2. The translation of a foreign operation's financial statements for inclusion in the consolidated financial statements.

The principal issues to be addressed are ”which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements

2 - Scope

This Standard shall be applied.

1. in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of SLFRS 9 Financial Instruments;
2. in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation or the equity method
3. in translating an entity’s results and financial position into a presentation currency.

3 - Summary of the approach required by LKAS 21

1. Each entity - whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) - determines its functional currency individually.

   In the case of group financial statements, it is emphasised that there is not a ‘group’ functional currency; each entity included within the group financial statements, be it the parent, or a subsidiary, associate, joint arrangement (whether a joint venture or joint operation) or branch, has its own functional currency.

2. Where an entity enters into a transaction denominated in a currency other than its functional currency, it translates those foreign currency items into

its functional currency and reports the effects of such translation in accordance with the provisions of LKAS 21.

3. The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with the provisions of LKAS 21.

4 - Definitions

Functional Currency	The currency of the **primary economic environment** in which the entity operates.
Presentation Currency	The currency in which the financial statements are presented.
Foreign Currency	A currency other than the functional currency of the entity.
Exchange Difference	The difference results from translating a given number of units of one currency into another currency at different exchange rates.
Exchange Rate	The ratio of exchange for two currencies.

4.1 - Determining an entity's functional currency

Functional currency is the currency of the **primary economic environment** in which the entity operates.

The primary economic environment in which an **entity operates is normally the one in which it primarily generates and expends cash**. An entity considers the following factors in determining its functional currency:

1. the currency:
    a) 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
    b) of the country whose competitive forces and regulations mainly **determine the sales prices** of its goods and services.
2. 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).

The following factors may also provide evidence of an entity's functional currency:

(a) the currency in **which funds from financing activities** (ie issuing debt and equity instruments) **are generated**.

(b) the currency in which **receipts from operating activities are usually retained**.

An operation that is 'integral' to its parent, i.e., it carries on business as if it were an extension of the parent's operations, will always have the same functional currency as the parent. (In this context, the term parent is drawn broadly and is the entity that has the foreign operation as its subsidiary, branch, associate or joint arrangement).

Therefore, the following additional factors are also considered in determining the functional currency of a foreign operation, particularly whether its functional currency is the same as that of the reporting entity:

- 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.
- Whether **transactions with the reporting entity** are a high or a low proportion of the foreign operation's activities.
- 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.
- 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.

Question 01 – Functional Currency

Chive is an entity located in a country whose currency is dollars ($). Seventy per cent of Chive's sales are denominated in dollars and 30% of them are denominated in sterling (£). Chive does not convert receipts from customers into other currencies. Chive buys most of its inventories, and pays for a large proportion of operating costs, in sterling.

Chive has two bank loans outstanding. Both of these loans are denominated in dollars.

Required: What is the functional currency of Chive?

4.2 - Identifying Monetary Items

- The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples;
    - employee benefits to be paid in cash
    - provisions that are to be settled in cash
    - lease liabilities
- The essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples;
    - amounts prepaid for goods and services
    - goodwill
    - intangible assets
    - inventories
    - property, plant and equipment
    - right- of- use assets

5 - Reporting foreign currency transactions in the functional currency

Foreign Currency Transaction	A transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity; • buys or sells goods or services whose price is denominated in a foreign currency • borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency • otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

5.1 - Initial Recognition

- A foreign currency transaction shall be initially recorded in the functional currency, by applying the spot exchange rate (the exchange rate on the date of the transaction).
- An average rate for a period may be used if exchange rates do not fluctuate significantly.

5.2 - Reporting at the ends of subsequent reporting periods

At the end of each reporting period:

- foreign currency **monetary items** shall be translated using the **closing rate**

- **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**
- **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 measured**

5.3 - Recognition of exchange differences

- Exchange differences arising on retranslation at the reporting date and on settlement are normally recognised in profit or loss in the period in which they arise.
- Where a gain or loss on a non-monetary item is recognised in other comprehensive income any related exchange differences are also recognised in other comprehensive income.

5.4 - Change in functional currency

- When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency **prospectively** from the date of the change.

- Once the functional currency is determined, it can be changed only if there is a change to those underlying transactions, events and conditions. For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency.

6 - Use of a presentation currency other than the functional currency

An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency.

- *For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented.*

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency as follows:

a) **Assets and liabilities** for each statement of financial position presented – Translated at the **closing rate** at the date of that statement of financial position;
b) **Income and expenses** for each statement of profit or loss and other comprehensive income – Translated at **actual exchange rates** at the dates of the transactions (**an average rate** for the period may be used if exchange rates do not fluctuate significantly)
c) All resulting **exchange differences** – Recognised **in other comprehensive income** (and, as a separate component of equity, the translation reserve).

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 shall be treated as assets and liabilities of the foreign operation. Thus, they shall be expressed in the functional currency of the foreign operation and **shall be translated at the closing rate**.

On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognised in other comprehensive income and accumulated in the separate component of equity, **shall be reclassified from equity to profit or loss** (*as a reclassification adjustment*) when the gain or loss on disposal is recognized.

7 - Disclosures

An entity shall disclose:

1. The amount of exchange differences recognised in profit or loss; and
2. Net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period

Please note that the disclosure requirements are continuously changing and updating. Therefore, referring to the standard is important for disclosures.