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Institute of Chartered Accountants of New Zealand

STATEMENT OF STANDARD
ACCOUNTING PRACTICE NO. 21
1998

ACCOUNTING FOR THE EFFECTS OF CHANGES IN FOREIGN CURRENCY EXCHANGE RATES

Issued by the Council
Institute of Chartered Accountants of New Zealand

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This Statement replaces SSAP-21, Foreign Currency — Disclosure, 1987, although the latter Statement will continue to apply until the completion of accounting periods which commenced prior to 1 July 1988.

Paragraphs 5.1, 5.2, 5.4, 5.7, and 5.9 – 5.13 (c) together with the relevant discussion paragraphs are withdrawn from 1 January 1998, at which time they are superseded by FRS-21: *Accounting for the Effects of Changes in Foreign Currency Exchange Rates*.

This Standard should be read in the context of the Explanatory Foreword to General Purpose Financial Reporting issued by the Council, Institute of Chartered Accountants of New Zealand.

1 INTRODUCTION

1.1 This Statement deals with

- translation of transactions denominated in foreign currencies;
- translation of the financial statements of foreign operations into a single reporting currency for the purpose of including them in the financial statements of the reporting entity.

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The Statement does not deal with accounting for foreign currency trading operations undertaken as a part of the normal business of the entity.

2 APPLICATION

2.1 The Standard in this Statement applies to all external financial statements.

2.2 This Statement becomes operative for financial statements covering periods beginning on or after 1 July 1988.

3 DEFINITIONS

3.1 *Reporting currency* is the currency used in presenting financial statements.

3.2 *Foreign currency* is a currency other than the reporting currency of an entity.

3.3 *Foreign operation* is a subsidiary, associate company, joint venture, branch or other form of operation, whose activities are based or conducted in a country other than that of the reporting entity. If the activities of a foreign operation are an integral part of those of the reporting entity, the operation is described as an integrated foreign operation; otherwise it is described as an independent foreign operation.

3.4 *Net investment in a foreign operation* is the reporting entity's equity share in the net assets of that operation.

3.5 *Exchange rate* is the ratio at which the currencies of two countries are exchanged at a particular time.

3.6 *Spot rate* is the exchange rate for immediate delivery of currencies to be exchanged.

3.7 *Forward rate* is the exchange rate available by the terms of an agreement for the exchange of two currencies at a future date.

3.8 *Closing rate* is the exchange rate in effect for spot transactions at the balance date of the reporting entity.

3.9 *Exchange difference* is the difference resulting from translating the same number of units of foreign currency at differing exchange rates.

3.10 *Monetary items* are money held and items to be received or paid in money. All other assets and liabilities are non-monetary items.

3.11 *Foreign currency loan* is a loan repayable in a foreign currency, regardless of the currency, or form, in which the loan was received.

3.12 *Foreign asset* is an asset usually permanently located in a foreign jurisdiction. The economic worth of such an asset is almost wholly determined by the economic environment of the foreign jurisdiction rather than the economic environment of the reporting entity.

3.13 *Long-term items* are those assets and liabilities not expected to be realised or settled within one year from balance date.

3.14 *Translation* is the process whereby financial data denominated in one currency are expressed in terms of another currency. It includes both the expression of individual transactions in terms of another currency and the expression of a complete set of financial statements prepared in one currency in terms of another currency.

3.15 *Transaction date* is the date at which a transaction is recorded in the accounting records of the reporting entity in conformance with generally accepted accounting principles.

3.16 *Settlement date* is the date at which a receivable is collected or a payable is paid.

4 DISCUSSION

4.1 A reporting entity may carry on foreign activities in two ways:

(a) It may have transactions in foreign currencies. For example, it may purchase or sell goods for which payment is made in a foreign currency, or it may lend or borrow foreign currency. In order to prepare the financial statements of the entity, transactions in foreign currencies must be translated into the reporting currency of the entity.

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(b) It may have foreign operations. In order to prepare financial statements incorporating the activities of foreign operations, the financial statements of those operations must be translated into the reporting currency.

4.2 The procedures which should be adopted when accounting for foreign activities are considered in three stages, viz:

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(a) translation of foreign currency transactions other than where hedging occurs (paragraphs 4.3 to 4.8);

(b) translation of financial statements of foreign operations (paragraphs 4.9 to 4.16); and

(c) hedging of foreign currency assets and liabilities (paragraphs 4.17 to 4.22).

Translation of Foreign Currency Transactions (Other Than Where Hedging Occurs)

4.3 Transactions denominated in a foreign currency should be translated into the reporting currency at the exchange rate ruling at the transaction date or at a rate approximating this rate.

4.4 When there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from the transaction, an exchange difference will result.

4.5 When a transaction is settled within the same accounting period as that in which it occurred, the exchange difference between the amount originally recorded and the settlement amount is reflected in the cash flows of the period and should be included as a foreign exchange gain or loss in the Profit and Loss Account of the period.

4.6 When a transaction is not settled in the same accounting period as that in which it occurred, the resulting foreign monetary item should be translated at the closing rate. This approach is based on the view that at balance date this rate is the best available estimate of the rate at which the transaction will ultimately be settled and therefore yields the most useful presentation of the financial position of the entity at balance date. Consequently, any difference between the amount presented in the current financial statements and the amount at which the transaction was recorded during the period or at which it was presented in previous financial statements is regarded as an unrealised foreign exchange gain or loss.

4.7 Practice varies with regard to the accounting treatment of unrealised gains and losses from foreign currency transactions. Such gains and losses on short-term monetary items are usually recognised in the Profit and Loss Account as they are identified. A similar practice is often followed for long-term monetary items but some defer such gains on the grounds of prudence but recognise losses in the Profit and Loss Account except to the extent of previously deferred gains. Some defer both gains and losses on long-term monetary items and recognise them in the Profit and Loss Account of current and future periods in a systematic basis over the remaining lives of the monetary items to which they relate.

4.8 The unrealised gains and losses are based on market data and represent the best available estimates of the ultimate gains and losses which will be reflected in the investing, financing or operating cash flows of future periods. It would be inconsistent to include unrealised exchange losses in the Profit and Loss Account but to defer unrealised gains, since these gains can be estimated no less objectively than exchange losses. Such an approach would inhibit fair measurement of the

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impact of foreign currency involvement on the performance of the enterprise and prediction of future revenue streams. Therefore, in accordance with the accrual concept of accounting, unrealised exchange gains and losses on monetary items should be included in the Profit and Loss Account of the period and not deferred and amortised to future periods.

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Translation of the Financial Statements of Foreign Operations

4.9 Various methods are currently in use for translating the financial statements of foreign operations. A number of methods apply different exchange rates to different assets and liabilities. Chief among these is a method that translates monetary items at the closing rate but other items at the rates in effect when the amounts of the relevant items were determined. When this method is followed, exchange differences arising on the translation of the foreign financial statements are usually regarded as gains or losses and recognised in the Profit and Loss Account. Another method is to translate all the assets and liabilities in the foreign financial statements at the closing rate. When this method is used, exchange differences arising on translation of the foreign financial statements are sometimes recognised in the Profit and Loss Account, and are sometimes taken to reserves.

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4.10 This Statement is based on the view that the method of translating the financial statements of foreign operations should be determined by an assessment of the operational and financial characteristics of those operations. For this purpose, foreign operations are regarded as belonging to one of two categories.

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4.11 In the first category are those foreign operations that accumulate cash and other monetary items, incur expenses and costs, realise revenues and perhaps arrange financing, all substantially in the foreign currency. When there is a change in the exchange rate, there is little or no direct effect on the activities or present and future cash flows of either the reporting entity or the foreign operation because the foreign operation is not an integral part of the operations of the reporting entity. The significance of the exchange rate change to the reporting entity would be based on its net investment in the foreign operation rather than on the particular mix of monetary and non-monetary items held by the foreign operation at the time of the rate change. Foreign operations of this type are referred to in this Statement as independent foreign operations.

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4.12 The second category of foreign operations comprises those that are an integral part of the operations of the reporting entity and are described in this Statement as integrated foreign operations. In such cases the effect on the reporting entity's cash flows following a change in the exchange rate would be almost immediate and would be similar to the one that would occur if the reporting entity had conducted the operation itself. Thus, the effect of an exchange rate change in the case of an integrated foreign operation is related to the monetary items held by the foreign operation rather than to the reporting entity's net investment in that operation.

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4.13 There is considerable variation in the operating relationships between reporting entities and their foreign operations. Whether a foreign operation should be regarded as independent or as integrated varies with the particular circumstances. Matters to be considered in making this decision include:

(a) Whether materials and other costs of the foreign operation's product are primarily local costs or whether the foreign operation depends on goods and services obtained primarily from the country in which the reporting entity is located.

(b) Whether there is little relationship between the day-to-day activities of the foreign operation and the reporting entity or whether transactions with the reporting entity represent a high proportion of the foreign operation's day-to-day activities.

(c) Whether the day-to-day activities of the foreign operation are financed mainly from its own operation and local borrowings or whether there is dependence on finance provided by the reporting entity.

(d) Whether the foreign operation's market is mainly outside the country of the reporting entity or inside it.

(e) Whether there are other factors that would indicate that the cash flows of the reporting entity are insulated from, or conversely, are affected by the day-to-day activities of the foreign operation.

4.14 Examples of situations where a foreign operation might be regarded as integrated are where the operation:

(a) acts as a selling agency which receives stocks of goods from the reporting entity and remits the proceeds to the reporting entity;

(b) produces a raw material or manufactures parts or sub-assemblies which are used by the reporting entity for inclusion in its own products;

(c) is located overseas for tax or other regulatory purposes or to act as a means of raising finance for other entities of the group.

4.15 It is appropriate in translating the financial statements of an independent foreign operation to preserve the results and the interrelationships of amounts appearing in the foreign financial statements. These results and interrelationships are regarded as providing the most meaningful indicator of the performance and financial position of the foreign operation for inclusion in the consolidated or combined financial statements of the reporting entity. This is achieved by translating the financial statements of the foreign operation at a single rate — the closing rate. The difference arising on translating the opening net investment at an exchange rate different from that at which it was previously reported should be excluded from the Profit and Loss Account and taken directly to a reserve (hereinafter referred to as "foreign currency translation reserve") because a change in the exchange rate has little or no direct effect on the activities of present and future operating cash flows of either the reporting entity or the foreign operation.

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4.16 For an integrated foreign operation, it is appropriate in translating its financial statements to incorporate the individual items of the foreign financial statements into those of the reporting entity in a manner that achieves the same effect as if all transactions of the foreign operation had been entered into by the reporting entity itself. Accordingly, both monetary and non-monetary items for the foreign operation should be translated in the same way as if those items had arisen from transactions engaged in by the reporting entity. That is, monetary items should be translated at the closing rate (with exchange differences included in the Profit and Loss Account) and non-monetary items should be translated at the rates in effect when the amounts of those items were determined. Profit and Loss Account items should be translated at exchange rates that correspond with the dates of the underlying transactions (or at rates approximating thereto).

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Hedging of Foreign Currency Assets and Liabilities

4.17 Entities engaging in foreign activities may engage in hedging transactions in order to eliminate or reduce exposure to the effects of fluctuations in exchange rates. An exposure may be hedged by entering into a forward exchange contract, by acquiring other specific foreign currency items (for example, a foreign asset to hedge a foreign payable or other liability) or by utilising existing foreign currency items. The reporting entity should formally record the designation of an item as a hedge.

4.18 Costs associated with hedge transactions other than those referred to in paragraph 4.20, should be recognised in the Profit and Loss Account over the life of the hedge transactions and should be accounted for separately from exchange differences arising on these hedge transactions.

4.19 If a short term foreign currency transaction is hedged by forward contracts, the forward rates specified in those contracts should be used as the basis for measuring and reporting the transaction.

4.20 Where a hedging transaction is undertaken to establish the price of particular goods or services to be purchased or sold, the exchange difference on the hedging transaction up to the date of purchase or sale, and any costs associated with the hedge transaction to that date, should be deferred and included in the measurement of the purchase or sale transaction. This procedure does not avoid the need to recognise in the financial statement losses which could arise from risk other than fluctuations in exchange rates.

4.21 If a foreign currency monetary item is designated as a hedge of a foreign currency monetary item, then at balance date both the item and the hedge should be translated at the closing rate and any exchange differences would offset each other.

4.22 Foreign currency monetary items should be translated at the closing rate and exchange differences arising should be recognised in the Profit and Loss Account of the period. Foreign currency non-monetary assets should be translated at the exchange rates in effect when the amounts of these assets were determined.

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However, if a foreign currency liability is designated as a hedge of a foreign currency non-monetary asset (or vice versa) then (a) for the period of the hedge the asset should be translated at the closing rate and the exchange difference taken to the foreign currency translation reserve, and (b) the exchange difference on the liability should be taken to the foreign currency translation reserve to the extent that it is offset by the exchange difference arising on the asset.

Following termination of the hedge the asset should, until sold, continue to be translated at the rate in effect on the hedge termination date.

4.23 Exchange differences on foreign currency monetary items should be recognised in the Profit and Loss Account of the period while differences arising from a net investment in an independent foreign operation should be taken to the foreign currency translation reserve. However, if a foreign currency liability is designated as a hedge of a net investment in an independent foreign operation, then the exchange difference on that liability should be taken to the foreign currency translation reserve to the extent that it is offset by the exchange difference arising on the net investment.

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4.24 A future income (expense) stream may be designated as a hedge of a foreign liability (asset), or vice versa, if it is reasonable to assume that the stream will accumulate over the next twelve months to an amount at least equal to the amount of the item being hedged. For the period of such a hedge, the liability (asset) should be translated at the closing rate and the exchange difference deferred and amortised. The amount amortised to the Profit and Loss Account should be equal to the exchange difference resulting from translation of the hedged item at the weighted mean rates for the current twelve month period and for the previous period.

If the hedged item is a non-monetary asset then on termination of the hedge, the asset should, until sold, continue to be translated at the rate in effect on the hedge termination date.

Foreign Currency Translation Reserve

4.25 Upon the sale, liquidation or settlement of any item originating exchange differences recognised in the foreign currency translation reserve, the relevant amount accumulated in the reserve should be transferred to the Profit and Loss Account and offset against any gain or loss on the sale, liquidation or settlement of the item.

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Classification of Exchange Differences

4.26 Exchange differences included in the Profit and Loss Account should not be described as extraordinary items unless the difference relates to an item which is itself extraordinary.

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Disclosure

4.27 Hedging may result in exchange differences on foreign currency liabilities being fully or in part offset by differences recognised in the foreign currency translation reserve. The aggregate amount so offset will correspondingly affect the net exchange difference included in the Profit and Loss Account for the period and should therefore be disclosed.

Where a future income (expense) stream hedges a foreign currency liability (asset), or vice versa, the exchange difference remaining to be amortised over the following period should be separately disclosed as part of current assets or current liabilities as appropriate.

5 STANDARD ACCOUNTING PRACTICE

Accounting for the Effects of Changes in Foreign Currency Exchange Rates

The Standards set out in the following paragraphs should be read in the context of the foregoing paragraphs of this Statement and the Explanatory Foreword to Statements of Standard Accounting Practice issued by the Council of the New Zealand Society of Accountants.

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Transactions

5.1 Except as provided in paragraph 5.3 transactions denominated in a foreign currency should be translated into the reporting currency by use of the exchange rate in effect at the transaction date or at a rate approximating this rate.

5.2 Except as provided in paragraph 5.3, at each balance date monetary items should be translated at the closing rate.

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5.3 For short term transactions covered by forward exchange contracts, the forward rates specified in those contracts should be used as the basis for measuring and reporting the transactions.

5.4 Except as provided in paragraphs 5.5 to 5.8, all exchange differences arising on settlement of monetary items or from reporting an entity's foreign currency monetary items at rates different from those at which they were recorded during the period or reported in previous financial statements, should be recognised in the Profit and Loss Account for the period.

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5.5 Where a hedging transaction is undertaken to establish the price of particular goods or services to be purchased or sold, the exchange difference on the hedging

transaction up to the date of purchase or sale, and any costs associated with the hedge transaction to that date, should be deferred and included in the measurement of the purchase or sale transaction. This procedure does not avoid the need to recognise in the financial statement losses which could arise from risk other than fluctuations in exchange rates.

5.6 If a foreign currency liability is designated as a hedge of a foreign currency non-monetary asset (or vice versa) then (a) for the period of the hedge the asset should be translated at the closing rate and the exchange difference taken to the foreign currency translation reserve, and (b) the exchange difference on the liability should be taken to the foreign currency translation reserve to the extent that it is offset by the exchange difference arising on the asset.

Following termination of the hedge the asset should, until sold, continue to be translated at the rate in effect on the hedge termination date.

5.7 If a foreign currency monetary liability is designated as a hedge of a net investment in an independent foreign operation, any exchange difference on that item should be taken to the foreign currency translation reserve to the extent that it is offset by the exchange difference on the net investment.

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5.8 If a future income (expense) stream is designated as a hedge of a foreign liability (asset), or vice versa (refer paragraph 4.24), then for the period of the hedge the liability (asset) should be translated at the closing rate and the exchange difference deferred and amortised. The amount amortised to the Profit and Loss Account should be equal to the exchange difference resulting from translation of the hedged item at the weighted mean rates for the current twelve month period and for the previous period.

If the hedged item is a non-monetary asset then on termination of the hedge, the asset should, until sold, continue to be translated at the rate in effect on the hedge termination date.

Financial Statements

5.9 The financial statements of an independent foreign operation should be translated at the closing rate and the exchange difference arising from translating the opening net investment at an exchange rate different from that at which it was previously reported should be taken to the foreign currency translation reserve.

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5.10 The financial statements of an integrated foreign operation should be translated in the same way as if the underlying transactions has been entered into by the reporting entity itself.

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Foreign Currency Translation Reserve

5.11 Upon the sale, liquidation or settlement of any item originating exchange differences recognised in the foreign currency translation reserve, the relevant amount accumulated in the reserve should be transferred to the Profit and Loss

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Account and offset against any gain or loss on the sale, liquidation or settlement of the item.

Classification of Exchange Differences

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5.12 Exchange differences included in the Profit and Loss Account should not be described as extraordinary items unless the difference relates to an item which is itself extraordinary.

Disclosure

5.13 There should be disclosure of:

(a) the methods used in translation of foreign-currency transactions and financial statements of foreign operations;

(b) the net exchange difference included in the Profit and Loss Account for the period;

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(c) a reconciliation of the opening and closing balances of the foreign currency translation reserve showing separately the aggregate amount offset in the reserve as a result of hedging foreign currency liabilities against foreign currency non-monetary asset and/or investment in independent foreign operations;

(d) the exchange difference remaining to be amortised as a result of hedging a foreign currency liability (asset) by a future income (expense) stream, or vice versa.

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