TOPIC 6.

ACCOUNTING STANDARD – 11

"EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES"

SCOPE OF THIS AS DEALS WITH:-

- *Treatment of Foreign Currency Transactions*
- *Translation of Financial Statements of Foreign Operations (Branch/Subsidiary)*
- *Forward Exchange Contracts*

I. FOREIGN CURRENCY TRANSACTIONS

DEFINITIONS

Currencies – *For the purpose of this AS, there are two types of Currencies*

(a) **Reporting Currency** – *Any Currency in which Financial Statements are reported.*

(b) **Foreign Currency** – *Any Currency other than Reporting currency.*

A **Foreign Currency Transaction** *is a transaction which is denominated in or requires settlement in a foreign currency for example – sale or purchase of goods in Foreign Currency, Borrowings or Lending or Investing in Foreign Currencies etc.*

Monetary items *are money held and assets and liabilities to be received or paid in fixed or*

determinable amounts of money. For example, cash, receivables and payables.

Non-monetary items *are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares.*

Foreign Currency Monetary Items *are Monetary Items which are to be settled in Foreign Currency (i.e. Receivable or Payable in Foreign Currency)*

RECOGNITION AND MEASUREMENT

Two important questions?

Q1. What is Initial Recognition?

Initial Recognition means first time recording in the books of accounts of Foreign Currency Transaction.

Q2. What is Subsequent measurement?

Subsequent Measurement means measurement at Balance Sheet date of Foreign Currency Monetary Items (FCMI) arising out of Foreign Currency Transactions.

Initial Recognition: All foreign exchange transactions are converted into reporting currency using **Spot exchange rate** or approximate rates *(i.e. the exchange rate prevailing on the date of Transaction).*

Examples of Foreign Currency Transactions:

- *Buying or selling of Goods and Services in Foreign Currency;*
- *Borrowing or Lending Money in Foreign Currency;*
- *Acquisition or Disposal of Assets in Foreign Currency;*
- *Incurring or Settling any Liability in Foreign Currency*

Subsequent Measurement:

- This recognition is applied on Foreign currency Monetary Items (FCMI) and Non Monetary Items carried at fair value or measured at other than cost.
- Subsequent measurement is applied for preparing financial statements.
- Any exchange difference arising on subsequent measurement at Balance Sheet date shall be transferred to ***Profit & Loss a/c.***

Financial Statement Items	Exchange Rates
Monetary Items (eg. Foreign Receivables or Payables)	Exchange Rate at the Reporting Date (i.e. Closing Exchange Rate)
Non-Monetary items at historical cost (eg. PPE)	Exchange Rate at the date of transaction (i.e. Spot Rate)
Revalued Non-monetary items or Items Measured at Fair Value (Eg. Inventory, Financial Instruments)	Exchange Rate at the date of Fair valuation or Revaluation Example: the cost or carrying amount, as appropriate, is translated at the exchange rate at the date when that amount was determined; and the net realisable value or recoverable amount, as appropriate, is translated at the exchange rate at the date when that value was determined.

Note: Foreign Currency Monetary Items (FCMI): FCMI are those ***Assets/Liabilities*** whose amount is ***Fixed*** under contract and they are to be ***settled in foreign currency***. For example Receivable, Payables, Cash Balances.

PARA 46 OF AS 11 on Treatment of Long Term Foreign Currency Monetary Items

Para 46 has been introduced in AS 11 with retrospective effect from 7th December 2006 amended on 31st March, 2009.

(a) Corporate/Non-Corporate entities can opt for the application of this Para & option is irrevocable till 31st March, 2020.

(b) FCMI of Long Term in nature (whose realization/payment is beyond 12 months from the date of original transaction) will be converted using closing rate in subsequent recognition.

Exchange difference arising from above point will be recognized as follows:

- Transfer Exchange difference to value of ***Depreciable Fixed Assets (PPE)*** if long term monetary item was taken to finance such Depreciable F.A. (i.e. to be capitalized if debit difference and subtracted if credit difference)
- Transfer Exchange difference to ***Foreign Currency Monetary Items Translation Diff a/c*** (FC MIT Diff a/c) if Long Term Monetary Item has no relation with Depreciable Fixed Assets.
- **FC MIT Diff a/c** will be amortised over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods (written off in periods equally by 31st March 2020 or till the life of LTFCMI whichever is earlier.)

The balance in FC MIT Diff a/c (debit or credit) should be shown on the "Equity and Liabilities" side of the balance sheet under the head "Reserves and Surplus" as a separate line item. (as decided by the council of ICAI)

2. TRANSLATION OF FINANCIAL STATEMENTS OF FOREIGN OPERATIONS

AS 11 (Effect of Changes in Foreign Exchange Rates), classifies the foreign branches as:

- **Integral Foreign Operation:** The activities of which are an integral part of those of the reporting enterprise (i.e. Head Office). An integral foreign operation carries on its business as **if it were an extension** of the reporting enterprise's operations. **(Example - Foreign Branch)**

- **Non-Integral Foreign Operation:** The business of such branch is carried on in a substantially independent way. **(Example – Foreign Subsidiary Co.)**

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A non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency.

TECHNIQUES FOR TRANSLATION:

(A) Integral Foreign Branch:

Items to be Translated	**Translation at**
Monetary Items (such as Debtors/creditors, Cash/Bank, Prepaid/Outstanding expense)	At Closing exchange rate
Non-Monetary items (such FA, Accum. depreciation on FA, Invesmentsetc)	At Cost i.e. at the exchange rate on the date of purchase
Opening Stock	Opening exchange rate
Closing Stock	Closing exchange rate
Revenue nature items (Incomes and expenses)	Average rate
Goods sent to branch a/c and HO a/c	Actual balance in HO books

Any Exchange difference arising on the translation of the Branch Trial Balance should be **transferred to Profit & Loss a/c** of HO.

(B) Non-Integral Foreign Branch:

1. Balance Sheet items i.e. Assets and Liabilites both Monetary and Non monetary apply Closing exchange rate.
2. Items of Income and Expenses – At the actual exchange rates on the date of transactions. However, AS 11 allows average rate subject to materiality.
3. Any Exchange rate difference should be accumulated in a "Foreign Currency Translation Reserve" (FCTR).
4. FCTR shall be accumulated under Reserves & Surplus as a separate line item.

5. **FCTR shall be reclassified to Profit and Loss account on Conversion from Non-Integral to Integral FO.**
6. **FCTR shall be reclassified to Profit and Loss account on sale/dispose of Non-Integral FO. However, if there is no disposal or sale of FO but only carrying amount is written off then no reclassification is allowed.**
7. **In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss.**

How to Identify Non-Integral Foreign Operation?

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

I. While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.

II. Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.

III. The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.

IV. Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.

V. The foreign operation's sales are mainly in currencies other than the reporting currency.

3. FORWARD EXCHANGE CONTRACTS (FEC)

Meaning:

- A FEC is an agreement between two parties where by one party agrees to buy or sell to other party an asset at future date for an agreed price.

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- In case of Forward contracts, the delivery is settled physically.
- These contracts are over the counter in an unregulated market.

Accounting Treatment:

FEC have been classified into two types for the purpose of accounting treatment:

(1) Forward exchange contracts entered for managing risk (Hedging)

(2) Forward exchange contracts entered for trading or speculation.

Forward Exchange Contracts entered For Managing Risk (Hedging):

- Any forward premium/discount should be amortized/recognized over the tenor of contract in the profit and loss a/c.
- If the forward contract is cancelled or renewed, the profit or loss arising on cancellation or renewal is recognized in the profit & loss statement for the period.

Forward Exchange Contracts entered for Trading or Speculation:

- Here forward premium/discount should be ignored.
- At each balance sheet date the value of contract is marked to market, any gain or loss on the contract is recognized immediately.
- Upon sell of forward contract, any profit or loss to be recognized immediately in the statement of profit & loss.

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Question 1

Kalim Ltd. borrowed US$ 4,50,000 on 01/01/2016, which will be repaid as on 31/07/2016. Kalim Ltd. prepares financial statement ending on 31/03/2016. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/2016 1 US$ = Rs 48.00

31/03/2016 1 US$ = Rs 49.00

31/07/2016 1 US$ = Rs 49.50

Solution

Journal Entries in the Books of Kalim Ltd.

Date	Particulars	Rs (Dr.)	Rs (Cr.)
Jan. 01, 2016	Bank Account (4,50,000 x 48) Dr.	216,00,000	
	To Foreign Loan Account		216,00,000
Mar. 31, 2016	Foreign Exchange Difference Account Dr.	4,50,000	
	To Foreign Loan Account		4,50,000
	[4,50,000 x (49-48)]		
Jul. 01, 2016	Foreign Exchange Difference Account Dr.	2,25,000	
	[4,50,000 x (49.5-49)]		
	Foreign Loan Account Dr.	220,50,000	
	To Bank Account		2,22,75,000

Question 2

Opportunity Ltd. purchased an equipment costing Rs 24,00,000 on 1.4.2015 and the same was fully financed by foreign currency loan (US Dollars) payable in four annual equal installments. Exchange rates were 1 Dollar = Rs 60.00 and Rs 62.50 as on 1.4.2015 and 31.3.2016 respectively. First installment was paid on 31.3.2016. The entire difference in foreign exchange has been capitalised. You are required to state that how these transactions would be accounted for.

Solution

As per AS 11 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, should be recognised as income or expenses in the period in which they arise. Thus, exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets will be recognised as income or expense.

Calculation of Exchange Difference:

Foreign currency loan =	Rs 24,00,000/60 = 40,000 US Dollars
Exchange difference =	40,000 US Dollars × (62.50-60.00) = Rs 1,00,000
(including exchange loss on payment of first instalment)	

Therefore, entire loss due to exchange differences amounting Rs 1,00,000 should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not availed the option for capitalisation of exchange difference as per paragraph 46/ 46A of AS 11.

However, as per paragraph 46A of the standard, the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset.

Accordingly, in case Opportunity Ltd. opts for capitalising the exchange difference, then the entire amount of exchange difference of Rs 1,00,000 will be capitalised to 'Equipment account'. This capitalised exchange difference will be depreciated over the useful life of the asset.

Cost of the asset on the reporting date

Initial cost of Equipment	Rs 24,00,000
Add: Exchange difference	Rs 1,00,000
Total cost on the reporting date	Rs 25,00,000

Question 3 **(May18 – RTP)**

Power Tram Ltd. purchased a plant for US$ 50,000 on 31st October, 2016 payable after 6 months The company entered into a forward contact for 6 months. @Rs 64.25 per Dollar. On 31st October, 2016, the exchange rate was Rs 61.50 per Dollar.

You we required to calculate the amount of the profit or loss on forward contract to be recognized m the books company for the yew ended 31 March, 2017.

Solution:

Calculation of profit or loss to be recognized in the books of Power Track Limited

	Rs
Forward contract rate	64.25
Less: Spot rate	(61.50)
Loss on forward contract	2.75
Forward Contract Amount	$ 50,000
Total loss on entering into forward contract = ($ 50,000 × Rs 2.75)	Rs1,37,500
Contract period	6 months
Loss for the period 1st November, 2016 to 31st March, 2017 i.e. 5 months falling in the year 2016-2017	5 months
Hence, Loss for 5 months will be Rs 1,37,500 × 6/5 =	Rs 1,14,583

Thus, the loss amounting to Rs 1,14,583 for the period is to be recognized in the year ended 31st March, 2017.

Question 4 **(Nov.18 – 5 Marks)**

I. ABC Ltd a Indian Company obtained long term' loan from WWW private Lid., a U.S. company amounting to Rs 30,00,000. It was recorded at US $1=Rs 60.00, taking exchange rate prevailing at the date of transaction. The change raw on lance sheet date (31.03.2018) was US $1=62.00.

II. Trade receivable includes amount receivable from Preksha Ltd., Rs 10,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = 59.00. The exchange rate on balance sheet date (31.03.2018) was US $1 = 62.00.

You are required to calculate the amount of exchange difference and also explain the accounting treatment needed in the above two cases as per AS 11 in the books of ABC Ltd.

Solution:

I. Rs. 100000 Exchange difference shall either be transfer to P&L a/c in the same year or entity may opt for Para 46 and transfer the difference to FCMIT Difference a/c and amortise it over the life of loan.

II. Rs. 50847 (approx.) shall be the exchange gain and transfer to P&L a/c in the same year.

Question 5

(ICAI Module)

Mr. A bought a forward contract for three months of US$ 1,00,000 on 1st December at 1 US$ = Rs 47.10 when exchange rate was US$ 1 = Rs 47.02. On 31st December when he closed his books exchange rate was US$ 1 = Rs 47.15. On 31st January, he decided to sell the contract at Rs 47.18 per dollar. Show how the profits from contract will be recognised in the books.

Solution

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

Sale Rate	Rs 47.18
Less: Contract Rate	(Rs 47.10)

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Premium on Contract Rs 0.08

Contract Amount US$ 1,00,000

Total Profit (1,00,000 x 0.08) Rs 8,000

A Ltd. purchased fixed assets costing Rs 3,000 lakhs on 1.1.2016 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs 40.00 and Rs 42.50 as on 1.1.2016 and 31.12.2016 respectively. First instalment was paid on 31.12.2016. The entire difference in foreign exchange has been capitalised.

You are required to state, how these transactions would be accounted for.

Solution

As per AS 11 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognised as income or expense.

Calculation of Exchange Difference:

Foreign currency loan = $\frac{\text{Rs 3000 lakhs}}{\text{Rs 40}}$ = 75 lakhs US Dollars

Exchange difference = 75 lakhs US Dollars × (42.50 – 40.00) = Rs 187.50 lakhs (including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting Rs 187.50 lakhs should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not exercised the option of capitalisation available under paragraph 46 of AS 11. However, if the company opts to avail the benefit

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given in paragraph 46A, then nothing is required to be done since the company has done the correct treatment.

Student Notes:-

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