Effects of Changes in Foreign Exchange Rates

(HKAS 21)

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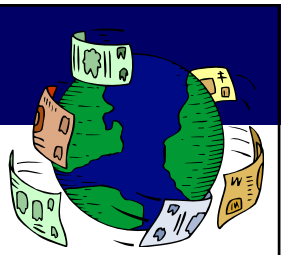
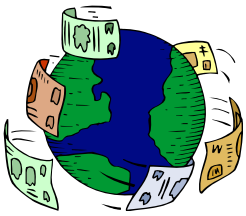
Today's Agenda



1. Objective and scope of HKAS 21
2. Approach in HKAS 21
3. Determine functional currency - Indictors
4. Translation foreign currency transactions
   - Initial recognition
   - Subsequent balance sheet date
   - Exchange difference
5. Translation foreign currency operation or whole set
   - Translation to presentation currency
   - Translation of foreign operation
   - Disposal of foreign operation
6. Disclosure
7. Effective Date and Transition

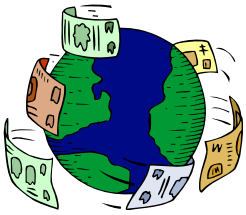
1. Objective and Scope of HKAS 21



- An entity may carry on foreign activities in 2 ways:
  a) having transactions in foreign currencies or
  b) having foreign operations.

  In addition, an entity may present its financial statements in a foreign currency.
- The objective of HKAS 21 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.
- The principal issues are
  - which exchange rates to use and
  - how to report the effects of changes in exchange rates in the financial statements.

1. Objective and Scope of HKAS 21



- HKAS 21 shall be applied:
  a) in accounting for transactions and balances in foreign currencies, except for those derivatives transactions and balances that are within the scope of HKAS 39
  b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and
  c) in translating an entity's results and financial position into a presentation currency.

2. Approach in HKAS 21

Determine Functional Currency	1. In preparing financial statements, each entity determines its functional currency.
Translate Foreign Currency Transactions	2. The entity translates foreign currency items or transactions into its functional currency and reports the effects of such translation.
Translate Foreign Operation or Whole Set	3. The results and financial position of any individual entity (say subsidiary, associate or branches) within the reporting entity (say parent) whose functional currency differs from the presentation currency of the reporting entity are translated. 4. If the entity's presentation currency differs from its functional currency, its results and financial position are also translated into the presentation currency.

2. Approach in HKAS 21

Determine Functional Currency

Translate Foreign Currency Transactions

Translate Foreign Operation or Whole Set

3. Indicators to Determine

Determine Functional Currency

1. In preparing financial statements, each entity determines its functional currency.

- Foreign currency is a currency other than the functional currency of the entity.
- Functional currency is the currency of the primary economic environment in which the entity operates.
- Presentation currency is the currency in which the financial statements are presented.

3. Indicators to Determine

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

- Primary indicators
  - a) the currency
    - i) that mainly influences sales prices for goods and services, and
    - ii) of the country whose competitive forces and regulations mainly determine the sales price of its goods and services.
  - b) the currency that mainly influences labour, material and other costs of providing goods or service.
- Other indicators in determining 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.

3. Indicators to Determine

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

- A reporting entity can also consider the following additional factors in determining the functional currency of its foreign operations, and whether their functional currency is the same as that of the entity itself:
  1. 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.
  2. whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.
  3. 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.
  4. 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.

3. Indicators to Determine

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

- When the above indicators are mixed and the functional currency is not obvious
  - management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.
- An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it
  - once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.
- If the functional currency is the currency of a hyperinflationary economy, the entity's financial statements are restated in accordance with HKAS 29
  - An entity cannot avoid restatement in accordance with HKAS 29 by, for example, adopting as its functional currency a currency other than the functional currency determined in accordance with HKAS 21 (such as the functional currency of its parent).

3. Indicators to Determine

Example

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

- If Entity A, a HK incorporated company, reports its financial statements in HK$.
- However, its head office is located in HK but only serves for accounting purpose.
- All the other operation, trading and finance souring are located in UK and all the transactions are denominated in UK GBP.
- Which currency is the foreign currency of Entity A under HK SSAP 11 and HKAS 21?

- Under HK SSAP 11
  - The reporting currency is → HK$
  - The foreign currency is → UK GBP
- Under HKAS 21
  - The functional currency is → UK GBP
  - The foreign currency is → HK$

3. Indicators to Determine

Example

- When an entity's foreign operation only sells goods imported from the entity and remits the proceeds to it
  - the foreign operation can be regarded as an extension of the entity
  - an extension of a reporting entity's operation is an indicator of having the same functional currency of the reporting entity
- When a foreign operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency
  - the operation can be regarded as being carried out with a significant degree of autonomy
  - an operation being carried out with a significant degree of autonomy is an indicator of having a different functional currency from the reporting entity

3. Indicators to Determine

Case

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

- Which functional currency and presentation currency are they having?

HSBC

Standard Chartered

3. Indicators to Determine

Case

Standard Chartered

Annual Report and Accounts 2006

- Accounting policy on foreign currency translation
  - Both the parent company financial statements and the Group financial statements
    - are presented in US dollars, which is the Group's functional and presentation currency.

HSBC

Annual Report 2006

- Items included in the financial statements of each of HSBC's entities
  - are measured using the currency of the primary economic environment in which the entity operates ('the functional currency').
- The consolidated financial statements of HSBC
  - are presented in US dollars, which is the Group's presentation currency.

3. Indicators to Determine

Case

Sing Lun Holdings Limited

- A apparel provider listed in the stock exchange of Singapore determined its functional currency in accordance with Singapore's accounting standards (equivalent to IAS) and explained in its annual report 2006 as follows:
  - The functional currency of the Company is Singapore dollars.
  - As revenue and expenses are denominated primarily in Singapore dollars and receipts from operations are usually retained in Singapore dollars, the directors are of the opinion that the Singapore dollars reflects the economic substance of the underlying events and circumstances relevant to the Company.

4. Foreign Currency Transactions

Determine Functional Currency

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Translate Foreign Currency Transactions

4a. Initial Recognition

- A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction
- Spot exchange rate is the exchange rate for immediate delivery
- The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with HKFRSs
  - For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period.

4b. Subsequent B/S Date

- At each balance sheet date:
  a) foreign currency monetary items
     ⇒ shall be translated using the closing rate;
  b) 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
  c) 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 determined.
- Closing rate is the spot exchange rate at the balance sheet date.

Retranslation required

NO retranslation

Retranslation at revaluation date

4b. Subsequent B/S Date

- Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.
  - Is debt security a monetary item?
  - Is equity security a monetary item?

4b. Subsequent B/S Date

Example

- Monetary items include:
  - Pensions and other employee benefits to be paid in cash
  - Provisions that are to be settled in cash
  - Cash dividends that are recognised as a liability
  - A contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency
- Non-monetary items include:
  - Amounts prepaid for goods and services
  - Prepaid rent
  - Goodwill and intangible assets
  - Inventories
  - Property, plant and equipment
  - Provisions that are to be settled by the delivery of a non-monetary asset

4b. Subsequent B/S Date

Case

Annual Report 2006

HSBC

- Transactions in foreign currencies
  - are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction.
- Monetary assets and liabilities denominated in foreign currencies
  - are translated into the functional currency at the rate of exchange ruling at the balance sheet date.
- Non-monetary assets and liabilities that are measured at historical cost in a foreign currency
  - are translated into the functional currency using the rate of exchange at the date of the initial transaction,
- Non-monetary assets and liabilities measured at fair value in a foreign currency
  - are translated into the functional currency using the rate of exchange at the date the fair value was determined.

4b. Subsequent B/S Date

Non-monetary Items at Other Amount in Foreign Currency

- An entity is sometimes required to measure in an amount other than historical cost by comparing 2 or more amounts.
- If a non-monetary asset is determined by comparing 2 or more amounts and is simultaneously measured in a foreign currency, the comparison should be made between:
  1. **The cost or carrying amount**, as appropriate, translated at the exchange rate at the date when that amount was determined

     i.e. the rate at the date of the transaction for an item measured in terms of historical cost), and
  2. **The net realisable value or recoverable amount**, as appropriate, translated at the exchange rate at the date when that value was determined

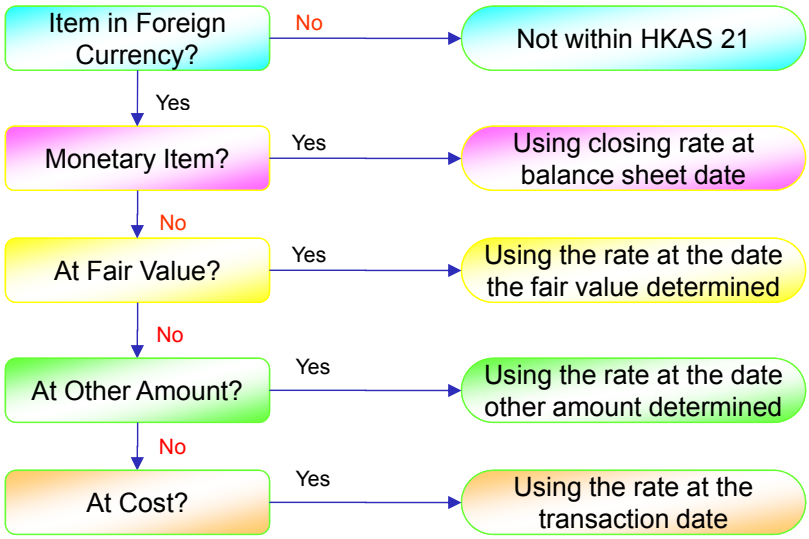
     e.g. the closing rate at the balance sheet date

4b. Subsequent B/S Date

Example

- An entity is required to determine the carrying amount of some items by comparing two or more amounts, for example:
  - In accordance with HKAS 2 *Inventories*,
    - the carrying amount of inventories is the lower of cost and net realisable value.
  - In accordance with HKAS 36 *Impairment of Assets*,
    - the carrying amount of an asset for which there is an indication of impairment is the lower of its carrying amount before considering possible impairment losses and its recoverable amount.

4b. Subsequent B/S Date



4c. Exchange Difference

Exchange Difference

- Exchange difference is the difference resulting from translating a given no. of units of one currency into another currency at different exchange rates.

On Monetary items

- Exchange differences arising
  - on the settlement of monetary items or
  - on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements

  shall be recognised in profit or loss in the period in which they arise, *except for those form part of net investment in a foreign operation*

On Non-monetary items

- When a gain or loss on a non-monetary item is recognised directly in equity
  - ⇒ any exchange component of that gain or loss shall be recognised directly in equity
- Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss
  - ⇒ any exchange component of that gain or loss shall be recognised in profit or loss

4c. Exchange Difference

Case

中国建设银行
China Construction Bank

Annual Report 2006

- Non-monetary assets and liabilities that are measured at fair value in foreign currencies
  - are translated using the foreign exchange rates at the date the fair value is determined.
- When the gain or loss on a non-monetary item is recognised directly in equity,
  - any exchange component of that gain or loss is recognised directly in equity, and all other foreign exchange differences arising from settlement and translation of monetary and non-monetary assets and liabilities are recognised in the income statement.

4c. Exchange Difference

Exchange Difference

- **On Monetary items**
- **On Non-monetary items**

- How's about an available-for-sale (AFS) financial asset?

HKAS 39.AG83 states:

- For the purpose of recognising foreign exchange gains and losses under HKAS 21
  - a monetary AFS financial asset is treated as if it were carried at amortised cost in the foreign currency
  - for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in P/L and other changes in carrying amount are recognised in accordance with HKAS 39.55(b) (mainly in equity)
- For AFS financial assets that are not monetary items under HKAS 21 (e.g. equity instruments)
  - the gain or loss that is recognised directly in equity in accordance with HKAS 39.55(b) includes any related foreign exchange component

4c. Exchange Difference

Example

- Entity A has a portfolio of investments in bonds purchased on 31 Oct. 2005 with the following details:

		Cost	Amortised cost	Market value
Unlisted in UK	GBP	800,000	820,000	900,000

  - The exchange rate of UK pound was HK$14 at 31 Oct. 2005 and HK$14.5 at 31 Dec. 2005.
- The entity has classified the investments in bonds as available-for-sale financial assets.
- If the functional currency of Entity A is HK$, discuss the implication of the above investment on the balance sheet and income statement.

4c. Exchange Difference

Example

- Investments classified as held-to-maturity can also be classified as available-for-sale as available-for-sale financial assets are defined as those non-derivative financial assets that:
  - i) are designated as available for sale or
  - ii) are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.
- Thus, Entity A can designate the investments in bonds initially as available-for-sale financial assets.
- If the investments in bonds are classified as such, they should be measured at fair value.
- The carrying amount for the bonds at fair value at 31 Dec. 2005:

	Market value	Exchange rate	Fair value in HK$
Unlisted in UK	GBP900,000	14.5	HK$ 13,050,000

- However, should all the fair value changes be recognised in equity?

4c. Exchange Difference

Example

- A gain or loss on an available-for-sale financial asset shall be recognised directly in equity, through the statement of changes in equity, except for:
  - impairment losses and foreign exchange gains and losses,

  until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss.
- As the investments in bonds are monetary items as explained, HKAS 39.AG83 requires that, for the purpose of recognising foreign exchange gains and losses under HKAS 21, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency.
- Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in profit or loss and other changes in carrying amount are recognised in equity.

4c. Exchange Difference

Example

- As explained by HKAS 39.IG.E.3.2, the cumulative gain or loss that is recognised in equity is the difference between the amortised cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity.
- In summary, investment in bonds in functional currency, HK$, at:
  - Cost (GBP 800,000 x 14) HK$ 11,200,000
  - Amortised cost (GBP 820,000 x 14.5) HK$ 11,890,000
  - Fair value (GBP 900,000 x 14.5) HK$ 13,050,000
- In consequence,
  - the difference between the amortised cost and fair value of HK$1,160,000 is recognised in equity.
  - the remaining gain of HK$690,000 is recognised in the income statement (what kinds of components are included?)

4c. Exchange Difference

Exchange Difference

On Monetary Items form part of *Net Investment in a Foreign Operation*

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

- Exchange difference is the difference resulting from translating a given no. of units of one currency into another currency at different exchange rates.
- Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation
  - ⇒ shall be recognised in profit or loss in the separate financial statements of the reporting entity, or the individual financial statements of the foreign operation, as appropriate.
- In the financial statements that include the foreign operation and the reporting entity (e.g. consolidated financial statements when the foreign operation is a subsidiary)
  - ⇒ such exchange differences shall be recognised initially in a separate component of equity and recognised in profit or loss on disposal of the net investment in accordance HKAS 21

4c. Exchange Difference

Exchange Difference

On Monetary Items form part of *Net Investment in a Foreign Operation*

Until 1.1.2006, such treatment is not applicable to the exchange difference arising from an item which is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation.

- Exchange difference is the difference resulting from translating a given no. of units of one currency into another currency at different exchange rates.
- Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation
  - ⇒ shall be recognised in profit or loss in the separate financial statements of the reporting entity, or the individual financial statements of the foreign operation, as appropriate.
- In the financial statements that include the foreign operation and the reporting entity (e.g. consolidated financial statements when the foreign operation is a subsidiary)
  - ⇒ such exchange differences shall be recognised initially in a separate component of equity and recognised in profit or loss on disposal of the net investment in accordance HKAS 21

4c. Exchange Difference

Case

HSBC

Annual Report 2006

- Exchange differences on a monetary item *that is part of a net investment in a foreign operation*
  - are recognised in the income statement of the separate financial statements.
  - In consolidated financial statements these exchange differences are recognised in the foreign exchange reserve in shareholders' equity.

In separate financial statements

In consolidated financial statements

4c. Exchange Difference

Case

ESPRIT

Esprit Holdings Limited

- 2005 Annual Report stated accounting policy on foreign currency transactions and balances
  - Foreign currency transactions are translated into the functional currency
    - using the exchange rates prevailing at the dates of the transactions.
  - Foreign exchange gains and losses resulting
    - from the settlement of such transactions and
    - from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies
    - are recognized in the income statement.

4d. 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.
  - Prospective accounting implies that an entity translates all items into the new functional currency using the exchange rate at the date of the change.
  - The resulting translated amounts for non-monetary items are treated as their historical cost.

4d. Change in Functional Currency

Case

Royal Dutch Shell plc

– One of the largest oil companies adopted IFRSs since 2005, changed its functional currency and explained in its annual report:

- Following Royal Dutch Shell becoming the parent company of Royal Dutch and Shell Transport on July 20, 2005 and through Royal Dutch and Shell Transport, of the rest of the Shell Group, the Directors have concluded that the most appropriate functional currency of the Company is dollars ……
- The previous functional currency of the Company was the euro.
- On the date of the change of functional currency all assets, liabilities, issued capital and other components of equity and income statement items were translated into dollars at the exchange rate on that date.
- As a result the cumulative currency translation differences which had arisen up to the date of the change of functional currency were reallocated to other components within equity.
- As a result of the change in functional currency the Company's functional and presentation currency are now the same.

5. Translate Foreign Operation

Determine Functional Currency

Translate Foreign Currency Transactions

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Translate Foreign Operation or Whole Set

5. Translate Foreign Operation

- 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.
  - in the translation, firstly to ascertain whether functional currency of an entity is a currency of a hyperinflationary economy

Functional currency is not a currency of a hyperinflationary economy

Functional currency is a currency of a hyperinflationary economy

5. Translate Foreign Operation

Functional currency is not a currency of a hyperinflationary economy

The results and financial position of such entity shall be translated into a different presentation currency using the following procedures:

a) assets and liabilities for each balance sheet presented (i.e. including comparatives)
   ⇒ shall be translated at the closing rate at the date of that balance sheet;

b) income and expenses for each income statement (i.e. including comparatives)
   ⇒ shall be translated at exchange rates at the dates of the transactions; and

c) all resulting exchange differences
   ⇒ shall be recognised as a separate component of equity.

Similar to SSAP 11 Net Investment Method

For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example, an average rate for the period, is often used to translate income and expense items.

5. Translate Foreign Operation

Functional currency is not a currency of a hyperinflationary economy

The exchange differences referred to above result from:

a) translating
   - income and expenses at the exchange rates at the dates of the transactions, and
   - assets and liabilities at the closing rate.

   Such exchange differences arise both on income and expense items recognised in profit or loss and on those recognised directly in equity.

b) translating the opening net assets at a closing rate that differs from the previous closing rate.

Similar to SSAP 11 Net Investment Method

5. Translate Foreign Operation

Case

中国建设银行
China Construction Bank

Annual Report 2006

- The assets and liabilities of overseas operations
  - are translated into Renminbi at the foreign exchange rates ruling at the balance sheet date.
- The revenue and expenses and cash flows of overseas operations
  - are translated into Renminbi at rates approximating the foreign exchange rates ruling at the date of the transaction.
- Foreign exchange differences arising from translation
  - are recognised directly in equity.

5. Translate Foreign Operation

Case

Li & Fung Limited

- Accounting policy on foreign currency transactions for group companies:
  - The results and financial position of all the Group entities (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:
    - i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
    - ii) income and expenses for each profit and loss account are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
    - iii) all resulting exchange differences are recognized as a separate component of equity.

5. Translate Foreign Operation

Functional currency is a currency of a hyperinflationary economy

The results and financial position of such entity shall be translated into a different presentation currency using the following procedures:

a) all amounts (i.e. assets, liabilities, equity items, income and expenses, including comparatives)

   ⇒ shall be translated at the closing rate at the date of the most recent balance sheet, except that

b) when amounts are translated into the currency of a non-hyperinflationary economy

   ⇒ comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (i.e. not adjusted for subsequent changes in the price level or subsequent changes in exchange rates)

5. Translate Foreign Operation

Functional currency is a currency of a hyperinflationary economy

- Such entity shall restate its financial statements in accordance with HKAS 29 before applying the translation method set out above, except for
  - comparative amounts that are translated into a currency of a non-hyperinflationary economy
- When the economy ceases to be hyperinflationary and the entity no longer restates its financial statements in accordance with HKAS 29
  - ➢ it shall use as the historical costs for translation into the presentation currency the amounts restated to the price level at the date the entity ceased restating its financial statements

5. Translate Foreign Operation

Exchange differences from intragroup elimination

- The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures (see HKAS 27 and HKAS 31).
- However, an intragroup monetary asset (or liability) cannot be eliminated against the corresponding intragroup liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements.
- Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference
  - continues to be recognised in profit or loss, or
  - if it arises from the circumstances that relating to monetary items that forms a part of net investment in a foreign operation, it is classified as equity until the disposal of the foreign operation.

5. Translate Foreign Operation

Foreign operation with a different reporting date

- The foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements.
- When this is not done, HKAS 27 allows the use of a different reporting date provided that the difference is no greater than 3 months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates.
- In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the balance sheet date of the foreign operation.
- Adjustments are made for significant changes in exchange rates up to the balance sheet date of the reporting entity in accordance with HKAS 27.
- The same approach is used in applying the equity method to associates and joint ventures and in applying proportionate consolidation to joint ventures in accordance with HKAS 28.

5. Translate Foreign Operation

Goodwill arising on acquisition

- 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

    (in accordance with the requirements on the functional currency which is or is not a currency hyperinflationary economy).

5. Translate Foreign Operation

Case

Kingsgate Consolidated Limited

- an Australia company adopted Australia financial reporting standards which are similar to equivalent to HKFRSs, stated clearly in its annual report 2006 as in respect of goodwill and fair value adjustments, as follows:
  - Goodwill and fair value adjustments arising on the acquisition of a foreign entity are
    - treated as assets and liabilities of the foreign entity and
    - translated at the closing rate.

5. Translate Foreign Operation

- On the disposal of a foreign operation, the cumulative amount of the exchange differences deferred in the separate component of equity relating to that foreign operation
  - shall be recognised in profit or loss when the gain or loss on disposal is recognised.

5. Translate Foreign Operation

Example

On 1.1.2006	Parent P	Sub S
Property	$ 0	¥ 6,000
Investment	0	0
Cash at bank	30,000	2,000
	30,000	8,000
Issued equity	$ (30,000)	¥ (5,000)
Retained earnings	0	(3,000)
	(30,000)	(8,000)

HK$1 = RMB 1 on 1.1.2007
HK$1 = RMB 1 on 1.1.2008
HK$1 = RMB 0.5 on 31.12.2008
(No profit for 2008 for P and S)

On 1.1.2007

- Parent P acquired 20% interest in Subsidiary S at $3,500 by cash.
- Fair value of the property of S was ¥8,000.

During 2007

- Parent P reported nil profit and profit of S was HK$6,000 (became cash).
- Fair value of S is HK$30,000 at year-end.
- P accounted for S as held for trading.

On 1.1.2008

- P acquired additional 60% interest in S at $22,000 by cash.
- Fair value of the property of S was ¥11,000.

5. Translate Foreign Operation

Example

On 1.1.2008	Parent P	Sub S	J#1	J#2	Consolidated
Property	$ 0	¥ 6,000		5,000	$ 11,000
Goodwill	0	0		12,100	12,100
Investment	28,000	0	(2,500)	(25,500)	0
Cash at bank	4,500	8,000			12,500
	32,500	14,000			35,600
Issued equity	$ (30,000)	¥ (5,000)		5,000	$ (30,000)
Retained earnings	(2,500)	(9,000)	2,500	7,800	(1,200)
Translation reserves	0	0			0
Revaluation reserves	0	0		(600)	(600)
Minority interest	0	0		(3,800)	(3,800)
	(32,500)	(14,000)			(35,600)

5. Translate Foreign Operation

Example

On 31.12.2008	Parent P	Sub S	Sub S
Property	$ 0	¥ 6,000	$ 12,000
Goodwill	0	0	0
Investment	28,000	0	0
Cash at bank	4,500	8,000	16,000
	32,500	14,000	28,000
Issued equity	$ (30,000)	¥ (5,000)	$(10,000)
Retained earnings	(2,500)	(9,000)	(18,000)
Translation reserves	0	0	0
Revaluation reserves	0	0	0
Minority interest	0	0	0
	(32,500)	(14,000)	(28,000)

Try this ……

Please prepare the consolidated balance sheet of Parent P as at 31.12.2008

5. Translate Foreign Operation

Example

Next ……

Step-by-step comparison

	1st Transaction 1.1.2007	2nd Transaction 1.1.2008	Total
Cost of combinations (or investments)	3,500	22,000	25,500
Fair value information			
Property, at fair value	8,000	11,000	
Cash	2,000	2,000	
Cash (profit for the year)	0	6,000	
	10,000	19,000	
Ownership interest	20%	60%	80%
Share of fair value	2,000	11,400	
Goodwill	1,500	10,600	12,100
	RMB At 1.1.2007	RMB At 1.1.2008	

5. Translate Foreign Operation

Example

Consolidation journals:

		Dr($)	Cr($)
Dr	Retained earnings	2,500	
Cr	Investment		2,500

To restate the initial 20% investment in Subsidiary S to cost

Dr	Property – fair value adjustment (¥5,000 ÷ 0.5)	10,000	
	Issued equity – subsidiary (¥5,000 ÷ 0.5)	10,000	
	Retained earnings – subsidiary (¥9,000 ÷ 0.5)	18,000	
	Goodwill (¥12,100 ÷ 0.5)	24,200	
Cr	Investment – cost of combinations		25,500
	Minority interest (¥3,800 ÷ 0.5)		7,600
	Retaining earnings recognised		1,200
	Revaluation reserves		600
	Translation reserves (balancing figure)		27,300

To recognise the goodwill and eliminate the investments with the equity shares

5. Translate Foreign Operation

Example

Calculation of translation reserves

- Net investment in Subsidiary S at RMB as at 1.1.2008:

Property	¥ 11,000
Cash	8,000
Goodwill	12,100
	¥ 31,100
Less: Minority interest	(3,800)
	¥ *27,300*
Re-translated at 31.12.2008 (at HK$1 =RMB 0.5)	$ 54,600
Balance recognised at 1.1.2008 (at HK$ 1 = RMB 1)	(27,300)
Exchange gain recognised in translation reserve	$ 27,300

5. Translate Foreign Operation

Example

On 31.12.2008	Parent P	Sub S	Sub S	J#1	J#2	Consolidated
Property	$ 0	¥ 6,000	$ 12,000		10,000	$ 22,000
Goodwill	0	0	0		24,200	24,200
Investment	28,000	0	0	(2,500)	(25,500)	0
Cash at bank	4,500	8,000	16,000			20,500
	32,500	14,000	28,000			66,700
Issued equity	$ (30,000)	¥ (5,000)	$(10,000)		10,000	$ (30,000)
Retained earnings	(2,500)	(9,000)	(18,000)	2,500	16,800	(1,200)
Translation reserve	0	0	0		(27,300)	(27,300)
Revaluation reserves	0	0	0		(600)	(600)
Minority interest	0	0	0		(7,600)	(7,600)
	(32,500)	(14,000)	(28,000)			(66,700)

5. Translate Foreign Operation

Case

HSBC

Annual Report 2006

- The results of branches, subsidiaries, joint ventures and associates not reporting in US dollars (HSBC's presentation currency)
  - are translated into US dollars at the average rates of exchange for the reporting period.
- Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end,
  - are accounted for in a separate foreign exchange reserve.

5. Translate Foreign Operation

Case

HSBC

Annual Report 2006

- Exchange differences on a monetary item that is part of a net investment in a foreign operation
  - are recognised in the income statement of the separate financial statements.
  - In consolidated financial statements these exchange differences are recognised in the foreign exchange reserve in shareholders' equity.
- On disposal of a foreign operation,
  - exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

5. Translate Foreign Operation

Case

ESPRIT

Esprit Holdings Limited

- 2005 Annual Report stated accounting policy on foreign currency transactions and balances
  - On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments,
    - are taken to shareholders' equity.
  - When a foreign operation is sold,
    - such exchange differences are recognized in the income statement as part of the gain or loss on sale.
  - Goodwill and fair value adjustments arising on the acquisition of a foreign entity
    - are treated as assets and liabilities of the foreign entity and translated at the closing rate.

6. Disclosure

- An entity shall disclose:
  a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with HKAS 39; and
  b) net exchange differences classified in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.
- When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency.
- When there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change in functional currency shall be disclosed.
- When an entity presents its financial statements in a currency that is different from its functional currency, it shall describe the financial statements as complying with HKFRSs only if they comply with all the requirements of each applicable Standard and each applicable Interpretation of those Standards including the translation method.

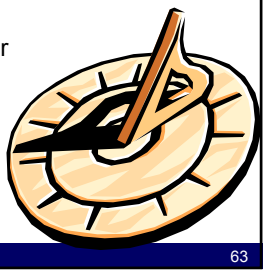
6. Disclosure

- When an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency and the requirements of the above paragraph are not met, it shall:
  a) clearly identify the information as supplementary information to distinguish it from the information that complies with HKFRSs;
  b) disclose the currency in which the supplementary information is displayed; and
  c) disclose the entity's functional currency and the method of translation used to determine the supplementary information.

7. Effective Date and Transition

- An entity shall apply HKAS 21 for annual periods beginning on or after 1 Jan. 2005.
  - Earlier application is encouraged.
  - If an entity applies HKAS 21 for a period beginning before 1 January 2005, it shall disclose that fact.
- An entity shall apply paragraph 47 of HKAS 21 (i.e. requirements on disposal of foreign operation) prospectively to all acquisitions occurring after the beginning of the financial reporting period in which this HKAS 21 is first applied.
  - Retrospective application of such requirements to earlier acquisitions is permitted.
- All other changes resulting from the application of HKAS 21 shall be accounted for in accordance with the requirements of HKAS 8.

How?



Effects of Changes in Foreign Exchange Rates

(HKAS 21) 19 November 2007

Full set of slides in PDF can be found in
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