

This accounting policy paper is based on IPSAS 4 The Effects of Changes in Foreign Exchange Rates, as adopted by the Treasury of the Republic of Cyprus.

# The Effects of Changes in Foreign Exchange Rates

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# 1. INTRODUCTION

## 1.1 PRINCIPAL ISSUES ADDRESSED

Which exchange rate to use?

How to report the effects of changes in exchange rates in the financial statements?

## 1.2 OBJECTIVES

The objective of this accounting policy is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of the entity, and how to translate financial statements into a presentation currency. The aim of this policy is to provide technical accounting guidance for the preparation of financial statements, so as to enable the financial statements to give a true and fair view. The aforementioned policy is prepared following guidance from all relevant International Public Sector Accounting Standards (IPSASs).

## 1.3 SCOPE

This accounting policy shall be applied in:

- a) accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of the accounting policy for Financial Instruments;
- b) translating the financial performance and financial position of foreign operations that are included in the financial statements of the entity by consolidation or by the equity method, as these are defined in the accounting policies of Consolidated Financial Statements and Investments in Associates and Joint Ventures; and
- c) translating an entity's financial performance and financial position into a presentation currency.

This accounting policy does not apply to the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation.

## 1.4 DEFINITIONS

**Closing rate** is the spot exchange rate at the reporting date.

**Exchange difference** is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

**Exchange rate** is the ratio of exchange for two currencies.

**Foreign currency** is a currency other than the functional currency of the entity.

**Foreign operation** is an entity that is a controlled entity, associate, joint arrangement or branch of the reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

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

**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, for example social security obligations and other employee benefits to be paid in cash, provisions that are to be settled in cash, cash dividends or similar distributions that are recognised as a liability. Examples of *non-monetary* items include amounts prepaid for goods and services (e.g. prepaid rent), goodwill, intangible assets, inventories, property plant and equipment, provisions that are to be settled by the delivery of a non-monetary asset.

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

**Presentation currency** is the currency in which the financial statements are presented.

**Spot exchange rate** is the exchange rate for immediate delivery.

Any other terms defined in other accounting policies that have been adopted by the government of the Republic of Cyprus, have the meaning presented in those accounting policies.

## 2. REPORTING FOREIGN CURRENCY TRANSACTIONS IN THE FUNCTIONAL CURRENCY

### 2.1 INITIAL RECOGNITION

*On initial recognition in the functional currency, a foreign currency transaction shall be recorded 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.*

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

- a) Buys or sells goods or services whose price is denominated in a foreign currency;
- b) Borrows or lends funds when the accounts payable or receivable are denominated in foreign currency; or
- c) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in foreign currency.

### 2.2 REPORTING AT SUBSEQUENT REPORTING DATES

At each reporting 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; and
- 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.

When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date.

If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.

## 2.3 RECOGNITION OF EXCHANGE DIFFERENCES

### 2.3.1 MONETARY ITEMS

1. Exchange differences arising on:

- a) the settlement of monetary items, or
- b) 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 **surplus or deficit** in the period in which they arise.

2. However, exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation shall be recognised as follows:

- a) in the separate financial statements of the reporting entity (in case the monetary item is denominated in the functional currency of the foreign operation) or the individual financial statements of the foreign operation (in case the monetary item is denominated in the functional currency of the reporting entity), as appropriate, recognised in the **surplus or deficit**.
- b) in the consolidated financial statements when the foreign operation is a controlled entity, initially recognised in a separate component of **net assets/ equity**. Upon disposal of the net investment exchange differences shall be recognised in **surplus or deficit**.

### 2.3.2 NON-MONETARY ITEMS

When a gain or loss on a non-monetary item is recognised:

- a) directly in net assets/ equity, any exchange difference component of the gain or loss shall also be recognised directly in **net assets/ equity**;
- b) in surplus or deficit, any exchange difference component of the gain or loss shall also be recognised in **surplus or deficit**.

## 2.4 FUNCTIONAL CURRENCY

### 2.4.1 DETERMINING THE FUNCTIONAL CURRENCY

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:

- a) The currency:

- i. That revenue is raised from, such as taxes, grants, and fines;
  - ii. That mainly influences sales prices for goods and services (e.g. the currency in which sales prices for goods and services are denominated and settled); and
  - iii. Of the country whose competitive forces and regulations mainly determine the sales price of goods and services.
- b) The currency that mainly influences labour, material, and other costs of providing goods and services.
  - c) The currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.
  - d) The currency in which receipts from operating activities are usually retained.
  - e) Whether the activities of a foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy.
  - f) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.
  - g) 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.
  - h) 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.

When the functional currency is not obvious, management uses its judgement to determine the functional currency. Priority shall be given to the primary indicators listed in 2.4.1 (a) – (b) of this accounting policy.

#### **2.4.2 CHANGES IN FUNCTIONAL CURRENCY**

In the event of a change of 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.

The entity shall translate 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. Exchange differences arising from the translation of a foreign operation previously classified in net assets/equity (as per paragraph 2.3.2 (b)) shall not be recognised in surplus or deficit until the disposal of the operation.

### 3. USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

#### 3.1 TRANSLATION TO THE PRESENTATION CURRENCY

- *Assets and liabilities;*
- *Revenue and expenses;*
- *Cash receipts and payments*

The financial performance and financial position of an entity with a functional currency that is not the currency of a hyperinflationary economy, shall be translated into a different presentation currency as follows:

- a) Assets and liabilities for each statement of financial position presented (i.e. including comparatives) shall be translated at the closing rate at the date of that statement of financial position;
- b) Revenue and expenses for each statement of financial performance (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions. Practically, a rate that approximates the exchange rates at the dates of the transactions can be used to translate revenue and expense items, for example an average rate for the period, if exchange rates do not fluctuate significantly;
- c) All resulting exchange differences shall be recognised as a separate component of net assets/ equity; and
- d) In translating the cash flows of a foreign operation for incorporation into its cash flow statement, the reporting entity shall use the exchange rate at the date of the cash flows. The presentation of any unrealised gains and losses arising from changes in foreign currency exchange rates on cash and cash equivalents held or due in a foreign currency, is set out in the accounting policy of Presentation of Financial Statements.

#### 3.2 TRANSLATION OF A FOREIGN OPERATION

Translation of a foreign operation is done as per paragraph 3.1 of this accounting policy so that the foreign operation can be included in the financial statements of the reporting



entity by consolidation or the equity method. The incorporation of the foreign operation in the reporting entity's financial statements follows normal consolidation procedures (e.g. elimination of balances and transactions within an economic entity), as described in the accounting policy of Consolidated Financial Statements.

However, a monetary asset (or liability) within an economic entity, whether short-term or long-term, cannot be eliminated against the corresponding liability (or asset) within an economic entity without showing the results of currency fluctuations in the consolidated financial statements. Therefore, in the consolidated financial statements of the reporting entity, such an exchange difference continues to be recognised in surplus or deficit or, if it arises from the circumstances described in paragraph 2.3.1(2) of this accounting policy, it is classified as net assets/ equity until the disposal of the foreign operation.

When there is a difference between the reporting date of the reporting entity and the foreign operation, the assets and liabilities of the foreign operation are translated at the exchange rate at the reporting date of the foreign operation. Further requirements for when the reporting period of the controlling entity is different from that of the controlled entity are specified in the accounting policy for Consolidated Financial Statements.

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 for the period, according to section 3.1 of this policy.

### **3.3 DISPOSAL OR PARTIAL DISPOSAL OF A FOREIGN OPERATION**

Ownership interest reductions to be accounted for as disposals:

- a) Disposal of the entire interest in a foreign operation;
- b) When a partial disposal involves the loss of control of a controlled entity that includes a foreign operation;
- c) When the retained interest, after the partial disposal of an interest in a joint arrangement or in an associate that includes a foreign operation, is a financial asset that includes a foreign operation.

All other forms of reductions in an entity's ownership interest in a foreign operation are accounted for as partial disposals.

An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of contributed capital, or abandonment of all or part of that entity. A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the entity holding the interest, does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised in surplus or deficit at the time of the write-down.

On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation and accumulated in a separate component of net assets/equity shall be reclassified from net assets/equity to surplus or deficit when the gain or loss on disposal is recognised. On the disposal of a controlled entity that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be transferred directly to accumulated surplus/ deficit.

On the partial disposal of a controlled entity that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences accumulated in a separate category of net assets/equity to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation, the entity shall transfer to accumulated surplus/ deficit only the proportionate share of the cumulative amount of the exchange differences accumulated in net assets/ equity.

## 4. DISCLOSURE

1. The entity shall disclose:

- a) The amount of exchange differences recognized in surplus or deficit, except for those arising on financial instruments measured at fair value through surplus or deficit; and
- b) Net exchange differences classified in a separate component of net assets/ equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

2. Whenever the presentation currency is different from the functional currency, it should be stated, together with disclosing the functional currency and the reason for using a different presentation currency.

3. Whenever there is a change in the functional currency of either the reporting entity or a significant foreign operation, it should be disclosed together with the reason for the change.

4. 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 IPSASs only if they comply with all the requirements of each applicable IPSAS, including the translation method.

5. 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 paragraph 4.4 above are not met, it shall:

- a) Clearly identify the information as supplementary information, to distinguish it from the information that complies with IPSASs;
- 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.

## 5. TRANSITIONAL PROVISIONS

1. The financial statements that are prepared following the first-time adoption of accrual basis IPSASs, will not account for cumulative translation differences that exist at the date of adoption of IPSASs. Instead:

- a) The cumulative translation differences for all foreign operations are deemed to be zero at the date of adoption of IPSASs;
- b) The gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of adoption of IPSASs and shall include later translation differences.

2. 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 prospectively on the date of adoption of IPSASs.

3. The above transitional provisions do not affect fair presentation and compliance with accrual basis IPSASs during the period of adoption.

## **6. EFFECTIVE DATE**

This rule shall be effective for annual financial statements covering periods beginning on or after 1 January 2020.

## **7. REFERENCES**

This accounting policy is based on the following IPSAS standards:

IPSAS 4 The Effects of Changes in Foreign Exchange Rates

IPSAS 33 First – time Adoption of Accrual Basis IPSASs

The Applicability of IPSASs