Foreign Currency Translations

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8

Learning Outcomes

After studying this chapter students should be able to:

- explain foreign currency translation principles;
- explain the correct treatment for foreign loans financing foreign equity investments.

8.1 Introduction

This chapter examines the provisions of IAS 21 dealing with the effects of foreign exchange rates. Section 8.2 looks at the objectives of the standard and some of the principal definitions it employs. Section 8.3 covers single transactions in foreign currencies. The most complex section of the chapter, Section 8.4, examines the calculations required to translate and then consolidate the financial statements of a foreign operation. Section 8.5 examines hedging of a foreign equity investment by a foreign loan.

8.2 IAS 21 *The effects of changes in foreign exchange rates*

IAS 21 was revised and reissued in December 2003 as part of the IASB's improvements projects. It incorporates several important alterations and so those students who have previously encountered foreign currency transactions regulated by the provisions of IAS 21 should study this chapter with care.

8.2.1 Foreign currency transactions: the accounting problem

Businesses frequently conduct transactions and make investments using foreign currencies. The accounting problem lies in the fact that the currency used in transactions is not the same as the currency in which the business entity conducts its normal operations. Therefore, in order to reflect the effect of the transactions in its own books and financial statements, the entity must use a method of currency translation.

A feature of foreign currency transactions is that they are subject to exchange risk, and that they may give rise to a loss (or, indeed, a profit) on translation.

8.2.2 IAS 21 Objectives and key definitions

The objective of IAS 21 is stated as follows:

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

Two distinct types of foreign activities are covered by the standard: first, single transactions in foreign currencies, and second, foreign operations.

A *foreign currency* is a currency other than the functional currency of the entity.

A *foreign operation* is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

The standard identifies and defines two types of currency: functional currency and presentation currency. *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.

As the distinction between the two implies, it is possible for an entity to report in a presentation currency that is not its functional currency.

Functional currency

Where an entity operates in several different national environments it may not always be a straightforward matter to determine its functional currency. Entities need to consider the following issues in determining their functional currency:

- Which currency principally influences selling prices for goods and services?
- Which country's competitive forces and regulations principally determine the selling prices of the entity's goods and services?
- In which currency are funds for financing activities (debt and equity instruments) generated?
- In which currency are receipts from operations generally kept?
- Which currency influences labour, material and other costs of providing goods or services?

Where consideration of the different factors does not result in a clear identification of the functional currency, the issue becomes a matter of judgement for management.

Presentation currency

The functional currency of an entity is a matter of fact, although identifying it may not be straightforward. By contrast, the entity's presentational currency is a matter of choice. IAS 21 permits an entity to present its financial statements in any currency it chooses; this may differ from the entity's functional currency. Why would an entity choose a presentation currency that is different from its functional currency? One of the following reasons may apply:

- The entity's functional currency is relatively obscure. The entity may then choose to report in a currency such as US dollars or Euros in order to make its financial statements more transparent.
- The entity's principal investors tend to function in another currency from the entity's own functional currency.

- The entity may be seeking investment from potential investors whose functional currency is not the same as the entity's functional currency.

8.3 Single transactions in foreign currencies

A single foreign currency transaction is one that is denominated in a foreign currency, or requires settlement in a foreign currency. Examples include:

- purchase or sale of goods or services where the price is denominated in a foreign currency;
- borrowing or lending of funds denominated in a foreign currency;
- acquisition or disposal of assets denominated in a foreign currency.

IAS 21 requires that the transaction should be recorded by translating the foreign currency amount into the entity's functional currency using the spot exchange rate at the date of the transaction (spot rate is the exchange rate for immediate delivery of the currency).

Example 8.A

On 1 July 20X0 entity A which reports in dollars purchased an asset from an entity reporting in euros for €200,000. Payment was made on 31 December 20X0. The entity's year end is 30 September.

Relevant exchange rates are:

Date	*Exchange rate* (as to $1)
1 July 20X0	1.50
30 September 20X0	1.40
1 December 20X0	1.45

How will this transaction be recorded in the books of A?

The initial recognition of the transaction is at spot rate on 1 July 20X0. The value of the transaction at that date is:

200,00/1.50 5 $133,333

The following journal records the transaction at 1 July 20X0:

	$	$
DR Asset	133,333	
CR Liability (supplier)		133,333

By A's year end the liability has still not been settled. IAS 21 requires that foreign currency monetary items should be translated using the closing rate at the entity's year end, and that non-monetary items should be translated using the exchange rate at the date of the transaction.

The asset itself is a non-monetary item; it is already included in the books of A using the rate at the date of the transaction, and so there is no need for any adjustment. The liability, however, is a monetary item, and so it must be retranslated at closing rate, as follows:

200,000/1.40 5 $142,857

This increases the liability at the year end (so there will be an additional credit to the supplier account of $142,857 – $133,333 = $9,524. The matching debit represents a loss on exchange, and IAS 21 requires that this should be taken to profit and loss. The year end journal entry in respect of this transaction, therefore, is:

	$	$
DR Income statement	9,524	
CR Liability (supplier)		9,524

By the settlement date, the exchange rate has moved again. On 31 December 20X0 A is obliged to pay €200,000. The cost of this to A in dollar terms is:

200,00/1.40 5 $142,857

However, the liability recorded in the books is $142,857; because of exchange rate movements, A is obliged to pay a lesser amount in dollar terms and so has realised a gain on exchange. The following journal entry records the transaction:

DR Liability (supplier)	142,857	
CR Cash		137,931
CR Income statement		4,926

8.4 Translating foreign operations

Sometimes, foreign operations such as subsidiaries, branches, associates and joint ventures operate using a different functional currency from that of the reporting entity. Where this is the case, the results, assets and liabilities of the foreign operation must be translated into a presentation currency, that is, the currency of the reporting entity.

The method employed is as follows:

(a) assets and liabilities should be translated using the closing rate at the year end date;
(b) income and expenses should be translated at the exchange rates in force at the date of the transactions;
(c) all resulting exchange differences are recognised as part of equity, until such time as the investment in the foreign operation is realised.

Point (b) could involve a foreign operation in a great deal of time consuming work. Therefore, it is accepted by IAS 21 that, for practical reasons, an average rate for the period may be used instead. However, if there are significant fluctuations in the exchange rate during an accounting period, it may not be acceptable to use the average rate.

Consolidation techniques are the same for foreign operations as for operations reporting under the same functional currency as the investor. The requirements of IFRS 3 *Business Combinations,* IAS 28 *Investments in Associates,* IAS 31 *Interests in Joint Ventures* and IAS 27 *Consolidated and Separate Financial Statements* apply equally to foreign operations.

Goodwill arising on the consolidation of a foreign operation should be recognised according to the requirements of IFRS 3. Such goodwill is treated as being an investment by the reporting entity in an asset, and it should be translated along with all other investee's assets at the closing rate. Fair value adjustments to the carrying amounts of assets and liabilities in the foreign operation should also be translated at the closing rate.

The techniques involved in translating a foreign operation are demonstrated in the following example.

Example 8.B

BLX holds several investments in subsidiaries. One of these, CMY, is located overseas. CMY prepares its financial statements in its local currency, the Crown.

Several years ago, when the exchange rate was 5 Crowns = 1$, CMY purchased land at a cost of 170,000 Crowns. On 1 June 20X5, when the exchange rate was 6.5 Crowns = $1 the land was revalued at a fair value of 600,000 Crowns. The exchange rate at the group's year end, 31 December 20X5, was 7 Crowns = $1.

In accordance with the requirements of IAS 21 *The effects of changes in foreign exchange rates*, at what value in $s should the land be recognised in BLX's group financial statements at 31 December 20X5?

Solution

IAS 21 requires that both the cost and any subsequent revaluiton should be translated at closing rate. The value of the revalued assets would then be 600,000/7 = $85,714.

Example 8.C

On 1 October 20X4 Erasmus acquired 80% of the ordinary issued share capital of Heinrich. Heinrich's functional currency is the groat (G). The cost of the investment was G800,000, and at the date of acquisition Heinrich's accumulated profits were G86,000. It is the group policy to value non-controlling interest at acquisition at the proportionate share of the fair value of the subsidiary's identifiable net assets.

Relevant rates of exchange are as follows:

Date	Gs to $1
1 October 20X4	4.0
30 September 20X8	3.9
30 September 20X9	3.75
Average for the year ended 30 September 20X9	3.8

The draft income statements, summarised statements of changes in equity and statements of financial position of Erasmus and its subsidiary are set out below:

Income statements for the year ended 30 September 20X9

	Erasmus $'000	*Heinrich* G'000
Revenue	10,290	10,650
Cost of sales	(5,145)	(5,325)
Gross profit	5,145	5,325
Other operating expenses	(4,116)	(4,260)
Profit from operations	1,029	1,065
Income from shares in Heinrich	64	–
Profit before tax	1,093	1,065
Income tax expense	(348)	(385)
Profit for the period	745	680

Summarised statements of changes in equity for the year ended 30 September 20X9

	Erasmus $'000	*Heinrich* G'000
Balance at start of period	1,252	1,336
Profit for the period	745	680
Dividends	(350)	(300)
Balance at 30 September 20X9	1,647	1,716

Summarised statements of financial position as at 30 September 20X9

	Erasmus $'000	*Heinrich* G'000
Property, plant and equipment	515	920
Investment in Heinrich	200	–
Net current assets	1,189	901
	1,904	1,821
Share capital	905	850
Retained reserves	742	866
	1,647	1,716
Loans	257	105
	1,904	1,821

Requirement

Prepare the summarised consolidated financial statements for the Eramus Group for the year to 30 September 20X9.

Work to nearest $000.

Solution

Erasmus group: Consolidated statement of financial position as at 30 September 20X9

	$'000
Goodwill on consolidation (W1)	13.7
Property, plant and equipment (515 + 245.3)	760.3
Net current assets (1,189 + 240.3)	1,429.3
	2,203.3
Share capital (Erasmus only)	905.0
Retained reserves (balancing figure)	921.8
	1,826.8
Non-controlling interest (W3)	91.5
Loans (257 + 28)	285.0
	2,203.3

Workings

1. *Goodwill on consolidation*

Goodwill on consolidation in G'000:

	G'000	G'000
Cost of acquisition ($200 × 4)		800
Acquired:		
Share capital	850	
Pre-acq reserves	86	
	936 × 80%	(748.8)
Goodwill on acquisition		51.2

Remember that IAS 21 requires that goodwill on consolidation is treated as an asset like any other, and translated at closing rate. So, goodwill in the consolidated statement of financial position is: G51,200/3.75 = $13,700 (rounded to the nearest $100).

2. *Translation of Heinrich's statement of financial position*

All of Heinrich's assets and liabilities are translated at closing rate:

	G'000	*Rate*	$'000
Property, plant and equipment	920	3.75	245.3
Net current assets	901	3.75	240.3
	1,821		485.6
Share capital	850	4.00	212.5
Pre-acquisition retained reserves	86	4.00	21.5
Post-acquisition retained reserves	780	Bal. fig	223.6
	1,716		457.6
Loans	105	3.75	28.0
	1,821		485.6

Note that share capital and pre-acquisition retained reserves are translated at 4.00, the exchange rate ruling at the date of acquisition. However, IAS 21 does not specify the rate at which equity items should be translated, and so closing rate could be used.

3. *Non-controlling interest*

The non-controlling interest is 20% of Heinrich's net assets: $457,600 × 20% = $91,500 (rounded to the nearest $100).

Note that the consolidation conventions applied are no different from the ones we have covered in previous chapters. The share capital is that of the holding entity only, 100% of the assets and liabilities of the subsidiary

are included, and a non-controlling interest is calculated in respect of the 20% of the net assets owned by shareholders other than Erasmus.

The retained reserves figure calculated for the moment is a balancing figure only. We will cover this in more detail when calculating the consolidated statement of changes in equity.

Erasmus group: Consolidated income statement for the year ended 30 September 20X9

	$'000
Revenue (10,290 + 2,802.64)	13,092.6
Cost of sales (5,145 + 1,401.3)	(6,546.3)
Gross profit	6,546.3
Other operating expenses (4,116 + 1,121.1)	(5,237.1)
	1,309.2
Tax (348 + 101.3)	(449.3)
Profit for the period	859.9
Attributable to:	
Equity holders of the parent	824.1
Minority interest (178.9 × 20%)	35.8
	859.9

4. *Translation of Heinrich's income statement*

This is translated throughout at the average exchange rate for the year, as required by IAS 21.

	G'000	*Rate*	$'000
Revenue	10,650	3.8	2,802.6
Cost of sales	(5,325)	3.8	(1,401.3)
Gross profit	5,325		1,401.3
Other operating expenses	(4,260)	3.8	(1,121.1)
Profit before tax	1,065		280.2
Income tax expense	(385)	3.8	(101.3)
Profit for the period	680		178.9

The next stage in the process is to prepare the consolidated statement of changes in equity. Note that this is a summarised statement only. In order to make the example relatively straightforward, equity is that relating only to equity holders of the parent.

A statement prepared in accordance with IAS 1 would require a breakdown into the components of share capital and various reserves, and also a column for non-controlling interests.

Erasmus group: Summarised consolidated statement of changes in equity for the year ended 30 September 20X9

	$'000
Brought forward at 1 October 20X8 (W5)	1,339.2
Profit for the period (see consolidated income statement)	824.1
Dividend (Erasmus only)	(350.0)
Exchange gains (balancing figure)	13.5
Carried forward at 30 September 20X9 (see consolidated statement of financial position)	1,826.8

It is clear from the circumstances of the question that the exchange differences will be gains, because of the direction of movements in the rates since acquisition (over time, fewer groats are required to buy $1, so an asset held in groats will produce gains). However, at the moment, we do not know exactly where the $13,500 in gains originates from. We can prove the figure, as shown in the following workings.

5. *Consolidated equity brought forward*

	$'000
Erasmus	1,252.0
Heinrich: 80% of post-acquisition profits (W6)	86.9
Exchange gain on goodwill on acquisition*	0.3
	1,339.2

	$'000
*Goodwill translated at date of acquisition 51,200/4	12.8
Goodwill at 30 September 20X8: 51,200/3.9	13.1
Exchange gain	0.3

6. *Heinrich: Post-acquisition profits*

Heinrich's opening equity is G1,336,000. Translated at the opening exchange rate of 3.9, the $ equivalent is: 1,336,000/3.9 = $342,600.

Post-acquisition profits at the start of the year = opening equity less share capital less pre-acquisition profits:

	$'000
Heinrich: opening equity	342.6
Share capital (see translated balance sheet in W2)	(212.5)
Pre-acquisition retained reserves (see translated statement of financial position in W2)	(21.5)
Heinrich: post acquisition profits	108.6

The group share of the post acquisition profits is 80%: $108.6 × 80% = $86.9 (figures in $'000).

7. *Proof of exchange gains*

These exchange gains arise because of the retranslation of the net assets of Heinrich. The proof is as follows:

	$'000	$'000
Opening net assets (G1,336,000) translated at:		
Opening exchange rate (1,336,000/3.9)		342.6
Closing exchange rate (1,336,000/3.75)		356.3
Gain on retranslation		13.7
Movement in equity in the year (G380,000)		
Profit for the period at average rate (680,000/3.8)	178.9	
Dividend (300,000/3.75)	(80.0)	
	98.9	
Movement in equity at closing rate (380,000/3.75)	101.3	
Gain on retranslation		2.4
Total gain on retranslation of net assets		16.1
Group share (80%)		12.9
Gain on retranslation of goodwill (working 8)		0.6
Total gain		13.5

8. *Gain for year on retranslation of goodwill*

Goodwill was calculated (see W1) as G51,200.

	$'000
Goodwill translated at 30 September 20X8: 51,200/3.9	13.1
Goodwill at 30 September 20X9 (see W1)	13.7
Exchange gain	0.6

Note that the group is attributed with only 80 per cent of the gain on the translation of net assets in Heinrich. The remainder is attributable to the non-controlling interest, and is included in the statement of financial position figure. However, the group is attributed with 100 per cent of the gain on the retranslation of goodwill. This is logical because the goodwill calculation does not concern the minority.

An examination question might require candidates to prove the exchange differences figure, and if it does, the requisite calculations are built into the time allowance for the question. However, if there is no positive requirement to prove the differences, it is sensible to simply slot them in as a balancing figure.

Note the treatment of the differences on exchange in this example. The differences are taken to the statement of changes in equity, as required by IAS 21.

8.4.1 Change in functional currency

The example of Erasmus and Heinrich demonstrates the procedures involved where the financial statements of a subsidiary entity have to be translated into the presentation currency used by the group as a whole.

Occasionally, an entity's functional currency will change because of alterations in business circumstances. The example given in the standard is where there is a change in the currency that mainly influences the prices of goods and services. Where this is the case, a retranslation exercise must be undertaken. IAS 21 requires that the retranslation must be undertaken *prospectively* from the date of the change. 'Prospectively' in this context means that the translation into the new functional currency takes place using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as being the historical cost of those items.

8.5 Hedging

Hedging establishes a relationship between a hedging instrument and a hedged item. A *hedged item* in the context of this chapter is a net investment in a foreign operation of the type that we have examined in the Erasmus and Heinrich example.

A *hedging instrument,* in the context of this chapter, is a financial liability whose cash flows are expected to offset cash flows of a designated hedge item.

Hedging relationships are now regulated by IAS 39 *Financial Instruments: Recognition and Measurement*, and the topic is covered in more detail in Chapter 13 of this *Learning System.* The particular kind of hedging relationship that is relevant to this present chapter relates to the financing of an investment in a foreign operation by a foreign currency loan taken out by the investing entity.

Example 8.D

G is an acquisitive entity that decides to purchase 75% of the share capital of H, an entity that operates outside G's country of operation, and whose functional currency is the Euro. The purchase price is €18.7 million, and G takes out a loan in euros to finance the purchase. The loan acts as a hedging instrument: any currency movements which adversely affect the investment in H (an asset) will be offset by currency movements in respect of the Euro loan (a liability). Provided that the hedge is designated as such, the exchange movements on both the investment and the hedge can be recognised as part of equity.

If hedging were not permitted, gains or losses on the investment in the foreign operation would be recognised as part of equity (as required by IAS 21) but gains or losses on the loan would be recognised in profit for the year. Hedging allows for recognition of the substance of the relationship between the investment and the loan that finances it.

8.6 Summary

This chapter has examined the provisions of IAS 21 *The Effects of Changes in Foreign Exchange Rates*, in respect of both single transactions and foreign operations. The distinction between functional and presentation currency is important, and students should ensure that they understand the definitions of each.

The translation and consolidation of foreign operations as part of a group is a significant element in the *Financial Management* syllabus. Students can expect that both the mechanics and the underlying principles of foreign operations translation will be examined on a regular basis. These underlying principles include the hedging of foreign equity investments via a foreign currency loan. The coverage of hedging is continued in more detail in Chapter 11 of this *Learning System* which covers the requirements of IAS 39.

Revision Questions

8

Question 1

The income statements for Home and its wholly owned subsidiary Foreign for the year ended 31 July 20X6 are shown below:

	Home	*Foreign*
	$'000	Crowns '000
Revenue	3,000	650
Cost of sales	(2,400)	(550)
Gross profit	600	100
Distribution costs	(32)	(41)
Administrative expenses	(168)	(87)
Finance costs	(15)	(10)
Profit before tax	385	(38)
Income tax	(102)	10
Profit for the period	283	(28)

Notes

1. The presentation currency of the group is the $, and Foreign's functional currency is the Crown.
2. Home acquired 100% of the ordinary share capital of Foreign on 1 August 20X4 for 204,000 Crowns. Foreign's share capital at that date comprised 1,000 ordinary shares of 1 Crown each, and its reserves were 180,000 Crowns. In view of its subsidiary's losses, Home's directors conducted an impairment review of the goodwill at 31 July 20X6. They concluded that the goodwill had lost 20% of its original value during the year (before taking exchange differences into account). The impairment should be reflected in the consolidated financial statements for the year ended 31 July 20X6. It is the group policy to value non-controlling intrest at acquisition at the proportionate share of the identifiable net assets of the subsidiary.
3. On 1 June 20X6, Home purchased an item of plant for 32,000 Florins. At the year end the payable amount had not yet been settled. No exchange gain or loss in respect of this item is reflected in Home's income statement above.
4. Exchange rates are as follows:

   On 1 August 20X4: 1.7 Crowns = $1
   On 31 July 20X6: 2.2 Crowns = $1
   Average rate for year ended 31 July 20X6: 2.4 Crowns = $1
   On 1 June 20X6: 1.5 Florins = $1
   On 31 July 20X6: 1.6 Florins = $1

5. During the year Foreign made sales of 50,000 Crowns to Home. None of the items remained in inventory at the year end.

Requirement

Prepare the consolidated income statement for the Home group for the year ended 31 July 20X6. (Work to the nearest $100). **(10 marks)**

Question 2

The statement of financial position of Big and Small as at 31 March 20X3 are given below. The statement of financial position of Small is prepared in florins, the reporting currency for Small.

	Big		*Small*	
	$'000	$'000	Fl'000	Fl'000
Non-current assets				
Property, plant and equipment	60,000		80,000	
Investments	9,500			
		69,500		80,000
Current assets				
Inventories	30,000		40,000	
Trade receivables	25,000		32,000	
Cash	3,000		4,000	
		58,000		76,000
		127,500		156,000
Issued capital and reserves				
Share capital (50 cents/½ florin shares)		30,000		40,000
Revaluation reserve		15,000		–
Retained reserves		34,500		44,000
		79,500		84,000
Non-current liabilities				
Interest-bearing borrowings	15,000		30,000	
Deferred tax	5,000		9,000	
		20,000		39,000
Current liabilities				
Trade payables	12,000		15,000	
Tax	16,000		18,000	
		28,000		33,000
		127,500		156,000

Notes

1. *Investment by Big in Small*
   On 1 April 20W7, Big purchased 60 million shares in Small for 57 million florins. The retained reserves of Small showed a balance of 20 million florins at that date. The accounting policies of Small are the same as those of Big except that Big revalues its land, whereas Small carries its land at historical cost. Small's land had been purchased on 1 April 20W4. On 1 April 20W7, the fair value of the land of Small was 6 million florins higher than its carrying value in the individual financial statements of that entity. By 31 March 20X3, the difference between fair value and carrying value had risen to 11 million florins. Apart from this accounting policy difference, no other fair value adjustments were necessary when initially consolidating Small as a subsidiary.

2. *Intra-group trading*
   On 6 March 20X3, Big sold goods to Small at an invoiced price of $6,000,000, making a profit of 25% on cost. Small recorded these goods in inventory and payables using an

exchange rate of 5 florins to $1 (there were minimal fluctuations between the two currencies in the month of March 20X3). The goods remained in the inventory of Small at 31 March 20X3 but on 29 March 20X3 Small sent Big a cheque for 30 million florins to clear its payable. Big received and recorded this cash on 3 April 20X3.

3. *Exchange rate*

Date	*Exchange rate* (Fls to $1)
1 April 20W4	7
1 April 20W7	6
31 March 20X2	5.5
31 March 20X3	5
Weighted average for the year to 31 March 20X3	5.2
Weighted average for the dates of acquisition of closing inventory	5.1

Requirements

(a) Translate the statement of financial position of Small as at 31 March 20X3 into $s and prepare the consolidated statement of financial position of the Big group as at 31 March 20X3. **(20 marks)**

(b) IAS 21 *The Effects of Changes in Foreign Exchange Rates* permits an entity to choose a presentation currency that is different from its functional currency.

Identify two possible reasons why an entity might choose to exercise this choice. **(5 marks)**

Total = 25 marks

Question 3

The statement of financial positions of Home and its subsidiary undertaking Away as at 31 March 20X6 and their income statements and statements of changes in equity for the year then ended are as follows (The functional currency of Away is the 'Mint' – the accepted abbreviation for 'Mint' is 'M').

Statement of financial positions as at 31 March 20X6

	Home		*Away*	
	$'000	$'000	M'000	M'000
Non-current assets				
Property, plant and equipment		20,000		30,000
Investment (notes 1 and 2)		5,500		
		25,500		30,000
Current assets				
Inventories	10,000		18,000	
Trade payables	10,000		15,000	
		20,000		33,000
		45,500		63,000
Capital and reserves				
Issued capital (1$/1M shares)		9,000		15,000
Retained reserves		12,500		10,000
		21,500		25,000
Long-term loans		10,000		20,000
Current liabilities				
Trade payables	7,900		10,400	
Bank overdraft	6,100		7,600	
		14,000		18,000
		45,500		63,000

Income statements – year ended 31 March 20X6

	Home	*Away*
	$'000	M'000
Revenue	50,000	60,000
Cost of sales (notes 2 and 4)	(25,000)	(30,000)
Gross profit	25,000	30,000
Other operating expenses	(15,000)	(16,000)
Dividend from Away	1,500	
Finance cost	(1,000)	(2,000)
Profit before tax	10,500	
Income tax expense	(3,600)	(4,200)
Profit for the period	6,900	7,800

Summarised statements of changes in equity – year ended 31 March 20X6

	Home	*Away*
	$'000	M'000
Balance at 1 April 20X5	18,500	21,600
Profit for the period	6,900	7,800
Dividends paid	(3,900)	(4,400)
Balance at 31 March 20X6	21,500	25,000

Notes

1. On 31 March 20X2 Home purchased 11.25 million shares in Away for M16.5 million. The retained reserves of Away on this date stood at M5 million.
2. Since the date of investment by Home the dollar has depreciated against the Mint. Exchange rates at relevant dates have been as follows:

Date	*Exchange rate* (Ms to $1)
31 March 20X2	3.00
31 March 20X5	2.40
Average for the year ended 31 March 20X6	2.35
31 March 20X6	2.20

3. Home received its dividend from Away when the exchange rate was M2.20 to $1.

Requirements

(a) Translate the balance sheet of Away into dollars and prepare the consolidated balance sheet of the Home group as at 31 March 20X6. **(11 marks)**

(b) Translate the income statement of Away into dollars and then prepare the consolidated income statement of the Home group for the year ended 31 March 20X6. **(6 marks)**

(c) Prepare the consolidated statement of changes in equity in respect of the holders of equity shares in the parent, for the Home group for the year ended 31 March 20X6. All figures in the statement should be supported by relevant workings. **(8 marks)**

(Total = 25 marks)

Work to the nearest $'000.

Solutions to Revision Questions

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Solution 1

Home group: Consolidated income statement for the year ended 31 July 20X6

	$'000
Revenue [3,000 + (650/2.4) − 20.8] (W1)	3,250.0
Cost of sales [2,400 + (550/2.4) − 20.8] (W1)	(2,608.4)
Gross profit	641.6
Distribution costs [32 + (41/2.4)]	(49.1)
Administrative expenses [168 + (87/2.4)]	(204.3)
Goodwill impairment (W2)	(1.9)
Exchange gain (W3)	1.3
Finance costs [15 + (10/2.4)]	(19.2)
Profit before tax	368.4
Income tax [102 − (10/2.4)]	(97.8)
Profit for the period	270.6

Workings

1. *Intra-group sales*
   Translate at average rate: 50/2.4 = $20.8
   Deduct from both revenue and cost of sales

2. *Goodwill on consolidation and impairment*

	Crowns'000
Cost of investment	204
Acquired	(181)
Goodwill	23

Impairment = 23,000 × 20% = 4,600 Crowns
Translated at average rate: 4,600/2.4 = 1.9 (to nearest $100)

Note: It would be quite acceptable to use closing rate for this calculation.

3. *Exchange difference on payable*

	$'000
Payable recognised on 1 June 2006: 32,000/1.5	21.3
Payable translated at closing rate: 32,000/1.6	(20.0)
Exchange gain	1.3

Solution 2

(a)

Step 1: Pre-adjust net assets for accounting policy change

	Date of acquisition	*Statement of financial position date*
	Fl'000	Fl'000
Share capital	40,000	40,000
Revaluation reserve	6,000	11,000
Retained reserves	20,000	44,000
	66,000	95,000

Step 2: Translate the statement of financial position of Small into $s (after incorporating the above adjustments)

	Fl'000	*Rate*	$'000
Non-current assets	91,000	5	18,200
Inventories	40,000	5	8,000
Receivables	32,000	5	6,400
Cash	4,000	5	800
	167,000		33,400
Share capital	40,000	6	6,667
Revaluation reserve:			
Pre-acquisition	6,000	6	1,000
Post-acquisition	5,000	5	1,000
Retained reserves:			
Pre-acquisition	20,000	6	3,333
Post-acquisition	24,000	Balance	7,000
	95,000		19,000
Interest bearing borrowings	30,000	5	6,000
Deferred tax	9,000	5	1,800
Trade payables	15,000	5	3,000
Tax	18,000	5	3,600
	167,000		33,400

Step 3: Prepare the consolidated statement of financial position

	$'000	$'000
Non-current assets:		
Property, plant and equipment (60,000 + 18,200)	78,200	
Goodwill on acquisition (W4)	1,500	
		79,700
Current assets:		
Inventories [30,000 + 8,000 + 1,200 (W2)]	36,800	
Receivables [25,000 + 6,400 − 6,000 (W2)]	25,400	
Cash [3,000 + 800 + 6,000 (W2)]	9,800	
		72,000
		151,700
Capital and reserves:		
Share capital		30,000
Revaluation reserve [15,000 + (75% × 1,000)]		15,750
Retained reserves (W5)		38,800
Non-controlling interest (W3)		4,750

Non-current liabilities:		
Interest bearing borrowings (15,000 + 6,000)	21,000	
Deferred tax (5,000 + 1,800)	6,800	
		27,800
Current liabilities:		
Trade payables (12,000 + 3,000)	15,000	
Tax (16,000 + 3,600)	19,600	
		34,600
		151,700

Workings

1. *Group structure*
   Big owns 60 million of the 80 million Small shares in issue. This is a 75% subsidiary.
2. *Intra-group trading*
   The unrealised profit made by Big is 25/125 × $6 million = $1.2 million. There is cash in transit of $6 million which needs adding onto consolidated cash and taking out of consolidated receivables.
3. *Non-controlling interest*
   25% × 19,000 = $4,750
4. *Goodwill*

	Fl'000	Fl'000
Cost of acquisition		57,000
Purchased:		
Share capital	40,000	
Pre-acquisition revaluation reserve	6,000	
Pre-acquisition retained reserves	20,000	
	66,000 × 75%	
		49,500
Goodwill		7,500

Translated at closing rate of 5: 7,500/5 = $1,500.

5. *Retained reserves*

		$'000
Big		34,500
Small: post acquisition 7,000 × 75%		5,250
Unrealised profit (W2)		(1,200)
Exchange gain on goodwill:		
Goodwill at acquisition: 7,500/6	1,250	
Goodwill at 31 March 20X3: 7,500/5	1,500	
		250
		38,800

(b) Two of the following reasons:

1. The entity's principal investors tend to function in a currency other than the functional currency of the entity.
2. The entity's functional currency is obscure; it may choose to present its financial statements in a better known currency such as the US dollar or the Euro.
3. The entity may be seeking investment from potential investors whose functional currency is not the same as the entity's.

4. In some jurisdictions, entities are obliged to prepare their financial statements in the local currency, even where this is not the functional currency.

Therefore, to avoid preparing two sets of financial statements, entities may prefer to choose the local currency as their presentation currency.

Solution 3

(a)

Step 1. Translate the balance sheet of Away (note that Away is a 75% subsidiary of Home).

	M'000	*Rate*	$'000
Property, plant and equipment	30,000	2.2	13,636
Inventories	18,000	2.2	8,182
Trade receivables	15,000	2.2	6,818
	63,000		28,636
Issued capital	15,000	3	5,000
Pre-acquisition profits	5,000	3	1,667
Post-acquisition profits	5,000	Balance	4,697
	25,000		11,364
Long-term loans	20,000	2.2	9,091
Trade payables	10,400	2.2	4,727
Bank overdraft	7,600	2.2	3,454
	63,000		28,636

Step 2. Prepare the consolidated balance sheet (notice that most figures are aggregations).

ASSETS	$'000	$'000
Non-current assets		
Goodwill on consolidation (W2)		682
Property, plant and equipment		33,636
		34,318
Current assets		
Inventories	18,182	
Trade receivables	16,818	
		35,000
		69,318
EQUITY AND LIABILITIES		
Equity		
Share capital (Home only)		9,000
Retained reserves (balancing figure)		16,205
		25,205
Non-conrtrolling interest (W1)		2,841
		28,046
Long-term loans		19,091
Current liabilities		
Trade payables	12,627	
Bank overdraft	9,554	
		22,181
		69,318

Workings

1. *Non-controlling interest*
   25% × 11,364 = 2,841

2. *Goodwill*

	M'000	M'000
Investment		16,500
Share capital	15,000	
Pre-acq. reserves	5,000	
	20,000 × 75%	
		15,000
Goodwill		1,500

Translated year end rate:

1,500/2.20 = $682

(b)

Step 1. Translate the income statement of Away into dollars

	M'000	*Rate*	$'000
Turnover	60,000	2.35	25,532
Cost of sales	(30,000)	2.35	(12,766)
Gross profit	30,000		12,766
Other operating expenses	(16,000)	2.35	(6,809)
Finance cost	(2,000)	2.35	(851)
Profit before tax	12,000		5,106
Income tax expense	(4,200)	2.35	(1,787)
Profit for the period	7,800		3,319

Step 2. Prepare the consolidated income statement (most figures are an aggregation)

	$'000
Turnover	75,532
Cost of sales	(37,766)
Gross profit	37,766
Other operating expenses	(21,809)
Finance cost	(1,851)
Profit before tax	14,106
Income tax expense	(5,387)
Profit for the period	8,719
Attributable to:	
Equity holders of the parent	7,889
Non-controlling interest (W1)	830
	8,719

Working

Non-controlling interest

This is 25% of the profit after tax of Away in dollars ($3,319) = $830.

(c)

Consolidated statement of changes in equity (attributable to equity holders of the parent)

	$'000
Balance at the start of the year (W1)	20,375
Profit for the year [see part (b)]	7,889
Dividend of Home	(3,900)
Exchange difference (W2)	841
Balance at the end of the year [see part (a)]	25,205

Workings

1. *Opening consolidated equity*

	$'000
Home	18,500
Away (75% × 2,333 − see below)	1,750
Exchange gain on goodwill*	125
	20,375

	$'000
*Goodwill at 31 March 20X5 $\left(\frac{1500}{2.40}\right)$	625
Goodwill at date of acquisition	500
	125

In order to compute the opening equity (and the post-acquisition change in equity, represented by post-acquisition profits) of Away, we need to translate the opening balance sheet (at last year's closing rate of M2.40 to $1):

	M'000	*Rate*	$'000
Issued capital	15,000	3.00	5,000
Pre-acquisition profits	5,000	3.00	1,667
Post-acquisition profits	1,600	Balance	2,333
Net assets and equity	21,600	2.40	9,000

2. *Exchange difference*

	$'000	$'000
Opening net assets:		
M21.6 m at M2.40 to $1		9,000
Opening net assets: M2.20 to $1		9,818
Increase (exchange gain)		818
Profit for the period:		
M7.8 m at M2.35 to $1	3,319	
Dividend: M4.4 m at M2.20 to $1	(2,000)	
	1,319	
Added to net assets: (M3.4 m) at M2.20 to $1	1,546	
		227
		1,045
Group share (75%) equals		784
Gain for year on retranslation of goodwill		
Goodwill at 31 March 20X5 (see above)	625	
Goodwill at 31 March 20X6 (balance sheet W2)	682	
		57
		841