

TECHNICAL NOTE
EFFECTS OF CHANGES IN FOREIGN CURRENCY
EXCHANGE RATES IAS 21

I. BACKGROUND

The International Accounting Standards Board (IASB), based in London, began operations in 2001. The Board is committed to developing, in the public interest, a single set of high quality general accounting standards that require transparent and comparable information in the financial statements. In pursuit of this objective, the Board cooperates with national accounting standard-setters around the world.

IASB publishes its Standards in a series of statements called International Financial Reporting Standards (IFRS). From its inception, the IASB adopted the body of International Accounting Standards issued by its predecessor, the Board of the International Accounting Standards Committee (IASC).

In certain cases, where an International Accounting Standard allows two accounting treatments for the treatment of similar transactions and events, one of them is known as *“benchmark treatment”* and the other as *“permitted alternative treatment”*.

The International Accounting Standards Board has developed IAS 21 EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES, which must be applied in the annual periods starting from January 1, 2005.

At the IX Meeting on Central Bank Accounting and Budgetary Aspects, it was decided to make a survey of the degree of compliance in the accounting of the Central Banks members of CEMLA with the IFRS, which was coordinated by the Accounting and Budget Committee.

The result of the survey enabled the Committee to identify the Standards that Central Banks consider difficult to apply, taking into account, on the one hand, the unique nature of the operations of Central Banks and, on the other hand, that their purposes and objectives differ from those sought by profit enterprises and, therefore, their financial statements require the application of special standards not envisaged in the IFRS and, because of the legislation existing in some countries there are impediments to their application. It was also found that some developed countries have not considered applying the IFRS and they follow their own regulations.

The Committee found that some IFRS standards, including IAS 21, had to be studied more thoroughly to determine their applicability. In reference to the IFRS,

the Committee agreed to prepare a technical note to contribute to a better understanding of the same by Central Banks associated with CEMLA. To that effect, a brief analysis of IAS 21 is provided below, together with an alternative procedure that Central Banks may adopt for its application.

I. SUMMARY OF IAS 21

0. Objective

An entity may carry out activities abroad in two different ways: it may conduct *transactions in foreign currency* or, it may have *foreign operations*. Also, the entity may present its financial statements in a foreign currency. This Standard is aimed at prescribing how to incorporate foreign currency transactions and foreign operations in an entity's financial statements, as well as how to convert the financial statements into the chosen reporting currency.

The main problems arising are the exchange rate(s) to use and the way to report the effects of changes in the exchange rates in the financial statements.

2. Scope

- a) This Standard must be applied in:
 - i) accounting for transactions and balances in foreign currency, except derivative-based transactions and balances within the scope of IAS 39, Financial Instruments: Recognition and Measurement;
 - ii) translating the results and financial position of foreign operations that are included in the financial statements of the entity either through proportional consolidation or the equity method; and
 - iii) translating the results and financial position of the entity into a presentation currency.
- b) This Standard does not deal with the hedge accounting for foreign currency items, including the hedge of a net investment in a foreign operation. Hedge accounting is addressed in IAS 39.
- c) This Standard is applied to the presentation of the financial statements of an entity in foreign currency and it establishes the requirements for the resulting financial statements to be able to be qualified as being in accordance with the International Financial Reporting Standards. The information to be disclosed, in the case of a translation of financial information into a foreign currency that does not meet the foregoing requirements is also specified.

3) Information in Functional Currency on transactions in foreign currency

Initial recognition

A transaction in foreign currency is any transaction whose amount is denominated in or requires settlement in foreign currency, including transactions where the entity:

- . buys or sells goods or services whose price is denominated in foreign currency;
- . borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
- i. acquires or disposes of assets, or incurs or settles liabilities, provided that these transactions have been denominated in foreign currency.

Any foreign currency transaction should be recorded, on initial recognition, by applying the cash exchange rate between the reporting currency and the foreign currency at the date of the transaction to the foreign currency amount.

4) Information of subsequent financial statements

- . At each balance sheet date:
 - i. *Foreign currency monetary items should be converted by using the closing exchange rate;*
 - ii. *Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be converted by using the exchange rate at the date of the transaction; and*
 - iii. *Non-monetary items which are carried at fair value denominated in a foreign currency should be converted by using the exchange rate that existed on the date this fair value is determined.*

5. Recognition of exchange differences

Exchange differences arising from the settlement of monetary items or on converting monetary items at rates different from those at which they were initially recorded, either occurring during the period or in previous financial statements, should be recognized as revenues or as expenses in the period in which they arise.

When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference should be recognized in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognized in each intervening period up to the date of settlement should be determined by the change in exchange rates that may have occurred during each period.

When the transaction is settled in the accounting period in which it occurred, any exchange difference should be recognized in said period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognized in each intervening period up to the date of settlement shall be determined by the change that may have occurred in exchange rates during each period.

When a loss or profit derived from a non-monetary item is directly recognized in equity, any exchange rate difference not included in said loss or profit shall also be recognized directly in equity. On the contrary, when the loss or profit derived from a non-monetary item is recognized in profit and loss for the period, any exchange difference included in this loss or profit should also be recognized in profit and loss for the period.

6. Information to be disclosed

The entity shall disclose the following information:

- i. The amount of the exchange differences recognized in profit and loss, except for those derived from financial instruments measured at fair value or changes in profit and loss, according to IAS 39; and
- ii. The net exchange rate differences classified as a separate component of equity and a reconciliation between the amounts of these differences at the beginning and end of the period.

II. APPLICATION OF IAS 21 IN CENTRAL BANKS

As can be inferred from the most important parts of IAS 21, transcribed in the above section, this Standard stipulates that exchange differences arising at the time of settling monetary differences or on the date of the financial statements, should be recognized as expenses or revenues for the period when they arise, except for the exchange differences derived from a monetary loss which is substantially a

part of the net investment made by the company in a foreign entity. In the case of Central Banks, this may be similar to the contributions made to international financial organizations and institutions; differences that should be classified as components of equity in the financial statements until the disposal of the investment takes place, at which time these shall be recognized as an expense or revenue.

The main duty of modern central banks is to maintain price stability. In addition to this basic duty, the by-laws or charters governing these institutions usually establish with varying degrees of differentiation that their basic objective consists of the design and execution of a monetary policy that ensures inflation control.

This inflation control requires that the monetary authority have sufficient credibility, so that economic agents, markets and society at large trust that its decision-making process is based on credible and stable foundations. The independence of Central Banks is one of the factors that seem to promote said credibility the most. Numerous studies have been conducted regarding the evidence of a correlation between the degree of independence of the Central Bank and the efficacy of its performance in controlling the inflationary phenomenon, which generally reveal that, indeed, there is an inverse correlation between independence and inflation level. Hence, the more independent the bank the better inflation will be controlled and at lower costs.¹

The IFRS establish that the objective sought by preparing financial statements in compliance with said rules is to “provide information on the situation, evolution and changes in the financial position of an entity, which is useful for a wide range of users to make their economic decisions”.

In the case of Central Banks, the essence of their operation is to maintain price stability and, for said purpose, the monetary policy exercise must be carried out regardless of the intrinsic profitability this may involve for the institution itself. Therefore, this may result in its exposure to risks that cannot be managed in a conventional manner.

Although it is true that for Central Banks profit may be used as a measure of the return on investments, it seems evident that unlike companies in general, their benefits do not represent any basis to enable evaluation of the performance of their activity or, at least, of their main activity, which is price control.

There are several reasons of a general nature by which an effort is made to emphasize that the basic conception of the IFRS is very different from the nature

¹ Antonio Rosas Cervantes, Banco de España, Central Banks should be subject to the IASs.

and objectives of Central Banks and, therefore, their application to the banks only be done through forced interpretations. IAS 21 is one of the Standards that may be particularly difficult to be applied by Central Banks.

IAS 21 stipulates that unrealized exchange profits and losses should be recorded in profit and loss for the period. Central Banks that do not have legal capacity to isolate this effect at the time of distributing their profits may experience certain problems.

The distribution of unrealized profits can have at least three undesirable effects for Central Banks: 1) interfere in the monetary policy exercise, since as it is well known that the distribution of profits of Central Banks involves an increase in the monetary base and in the case of distribution of realized profit, said increase is subsequent to the reduction thereof; 2) increase the volatility of profits and lead to their financial weakening, and 3) permit the existence of a possible hidden loan to the Public Treasury.

Therefore, if, as stated above, the legal provisions regulating the profit distribution system of the Central Bank do not prevent the distribution of unrealized profits, interferences in the exercise of its monetary policy may occur, exclusively derived from the application of accounting rules that do not take into account some of the basic characteristics of these institutions.

The application of accounting standard contained in IAS 21 may not be applicable to some Central Banks whose laws contain clear-cut prohibitions about considering as expenses or revenues the differences arising from the valuation of the monetary or non-monetary liability or asset accounts, since this procedure would lead Central Banks to charge or transfer to the State the amounts of the unrealized losses or profits, derived from the appreciation or depreciation of local currency exchange rate against foreign currencies and, in this respect, the same laws envisage alternative procedures such as recording said differences as a part of equity, a procedure that is compatible with the guidelines of IAS 21 for the case of investments in foreign entities.

IV. ALTERNATIVE PROPOSAL FOR A GENERAL FRAMEWORK OR ACCOUNTING CRITERIA

Due to the foregoing, it is considered that the following may be an appropriate procedure for Central Banks to record foreign currency transactions and the exchange rate differences arising at the time of settling monetary items or at the date of the financial statements:

- a. Any foreign currency transaction should be recorded at the time of initial recognition by using the functional currency, by applying to the foreign currency amount the cash rate prevailing on the date of the transaction between the functional currency and the foreign currency.
- b. Foreign currency monetary amounts should be converted by using the closing rate prevailing on the date of presentation of the financial statements;
- c. Non-monetary items, originally established in foreign currency, carried at historical cost should be valued through the cash exchange rate at the date of the transaction; and
- d. Non-monetary items, originally established in foreign currency, carried at fair value, should be valued by using the cash exchange rates that existed when said fair value was determined.

Unrealized profits derived from the translation of monetary items, on the date of the financial statements, due to exchange rates different from those used for recording the transaction in the period or to report it in previous financial statements should not be recognized as revenues. Instead, these will be directly transferred to a Revaluation Reserve account that is a part of equity in the financial statements of Central Banks, until monetary items are settled. These will then be subject to recognition as a revenue or expense, depending on the sale price and the average cost of the monetary item.

Unrealized losses will be allocated to the profit and loss account when they exceed previous revaluation profits recorded in the relevant revaluation reserve account.

Unrealized losses allocated to the profit and loss account may not be set off in the following years with new unrealized profits. Unrealized losses on a foreign currency will not be set off with unrealized profits on other securities, currencies or gold holdings.

Losses or profits arising from a monetary item substantially pertaining to the net investment made by the Central Bank in a foreign entity (contributions to international financial organizations or entities) must be recorded in a Revaluation Reserve account as components of equity, in the financial statements of Central Banks, until disposal of the investment takes place, at which time these shall be recognized as an expense or revenue in the same period when losses or profits derived from said disposal are recognized.

Information to be disclosed

Central Banks should disclose the following in their financial statements:

1. The amount of exchange differences that have been included in the net profit or loss for the period;
2. Exchange differences in net terms that have been classified as components of equity, as well as a reconciliation of balances arising from differences at the beginning and end of the period.

II. CONCLUSION

In recognizing unrealized profits or losses in the monetary or non-monetary items on the date of presentation of the financial statements due to fluctuations in the functional exchange rates in comparison with foreign currency, these should not be treated as a revenue or expense for the accounting period, since these have not been caused yet and they are only aimed at reflecting the foreign currency asset and liability accounts through their equivalence in local currency.

Losses or profits derived from exchange rate fluctuations may be adjusted in the course of time without impacting the results of Central Banks and in this respect the most appropriate measure is to treat them as an equity adjustment due to revaluation or devaluation of local currency, which shall be caused only if the Central Bank settles the currencies or investments that give rise to the former.