IPSAS 4
The Effects of Changes in Foreign Exchange Rates

Guidelines

IPSAS Implementation Team

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Introduction

1. IPSAS 4 The Effects of Changes in Foreign Exchange Rates– as adopted by the Maltese Government

1.1. These guidelines refer to the **Effects of Changes in Foreign Exchange Rates** accounting standard **as adopted by the Maltese Government**. This version is based on the original IPSAS 4 developed by the International Public Sector Accounting Standards Board (IPSASB). Modifications were made to the original standard to make it more applicable to the local context.

2. Scope

2.1. These guidelines were prepared to enable the users to:

2.2. Develop a working-level knowledge of the principles contained in the accounting standard; and

2.3. Understand and appreciate the major challenges and benefits resulting from the implementation of IPSAS 4[1].

3. Target Audience

3.1. These guidelines are designed for finance and non-finance employees employed in Ministries and Departments of the Government of Malta.

4. Guidelines Structure

4.1. These guidelines shall provide a detailed overview of all the principles contained in the standard. 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.

[1] References to IPSAS 4 or any other IPSAS shall be taken as meaning 'as adopted by the Maltese Government'.

A. Functional Currency

1.1 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*

1.2 The <u>currency</u>:

1.2.1 That revenue is raised from, such as taxes, grants, and fines;

1.2.2 That mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

1.2.3 Of the country whose competitive forces and regulations mainly determine the sale prices of its goods and services.

1.2.4 That mainly influences labour, material and other costs of providing goods and services (this will often be the currency in which such costs are denominated and settled).

1.2.5 In which funds from financing activities (i.e., issuing debt and equity instruments) are generated.

1.2.6 In which receipts from operating activities are usually retained.

1.3 The following <u>additional factors</u> are considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity (the reporting entity, in this context, being the entity that has the foreign operation as its controlled entity):

1.3.1 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 (e.g. an embassy which operates under the management and direction of the Ministry).

1.3.2 Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

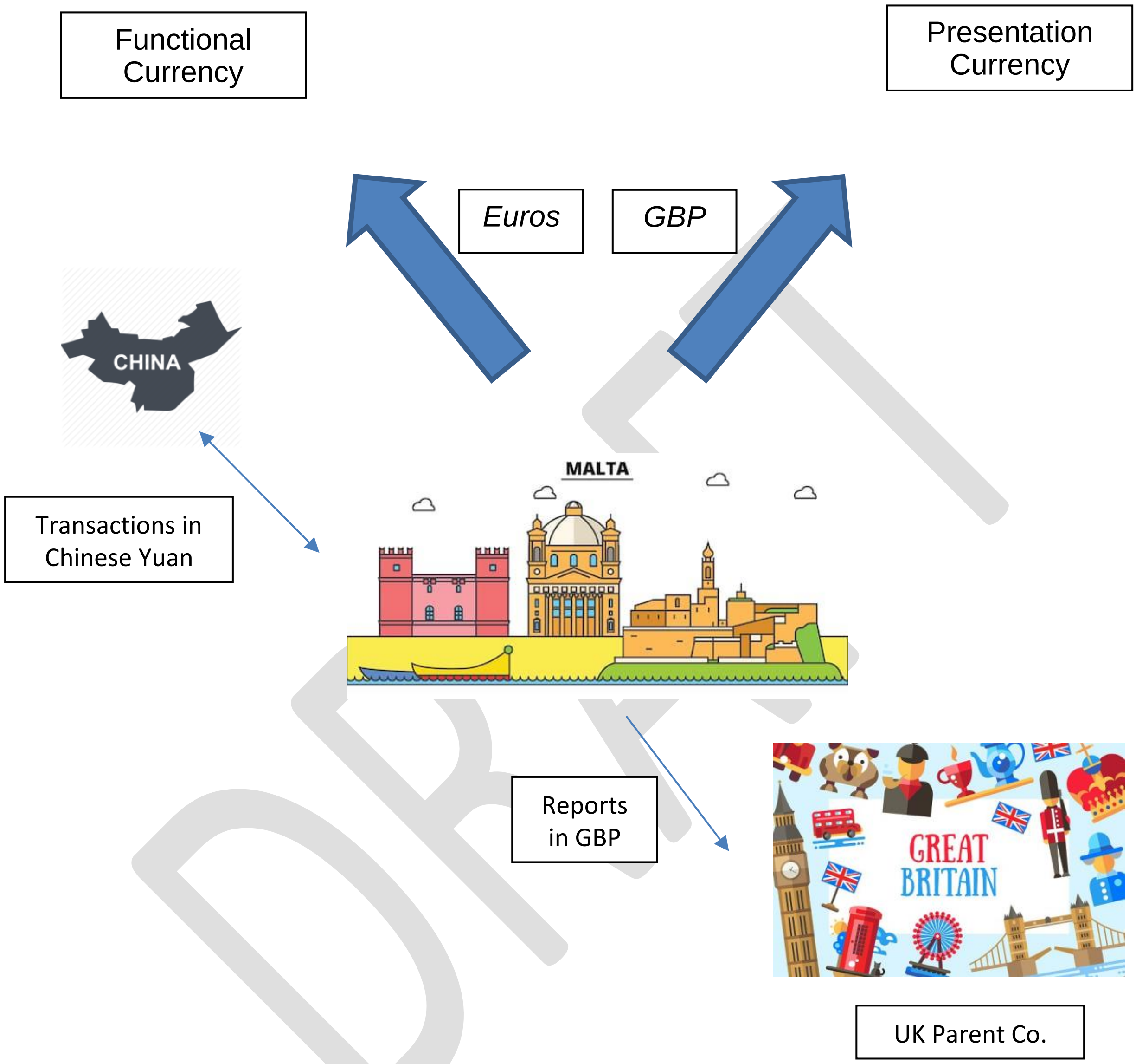
1.3.3 Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

1.3.4 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.

1.4 Therefore the functional currency should be the one in which the ministry or department normally generates and spends cash, and that in which transactions are normally denominated.

1.5 When the above indicators are mixed and the functional currency is not obvious, the standard points towards management judgment. However in this case the Treasury is to be consulted to assist the respective ministry or department to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Example 1:



- ✓ The Maltese Co.'s primary economic environment is the Euro, therefore the Euro is the functional currency of the Co.
- ✓ The Maltese Co. buys goods from China therefore it will need to translate transactions from Chinese Yuan to the Euro.
- ✓ The Maltese Co. is a subsidiary of a UK Co. and therefore will need to present financial reports in GBP.

<u>Functional currency</u> is the currency of the primary economic environment in which the entity operates. It is the own entity's currency and all other currencies are "foreign currencies". The functional currency of the Government of Malta is the Euro.

<u>Presentation currency</u> is the currency in which the financial statements are presented. The presentation currency of the Government of Malta is the Euro.

Example 2:
Department X bought goods from China on 1 December 2018 for 200,000 Yuan. The department paid for the goods on 5 February 2019. If Department X's year end is 31 December, show how Department X recorded this transaction.
Rates of Exchange
1 December 2018 1 Chinese Yuan: 0.135 Euro
31 December 2018 1 Chinese Yuan: 0.131 Euro
5 February 2019 1 Chinese Yuan: 0.139 Euro

Solution

(a) <u>Purchase of goods (1 December rate of exchange):</u>

Debit Purchases	€27,000
Credit Payables	€27,000
Being Purchases of goods from China	

(b) <u>Reporting of Payable at 31 December 2018 (31 December rate of exchange)</u>

Debit Payable	€800 [£27,000 - £26,200] – decrease in payable @31/12
Credit Foreign Exchange gain	€800
Being amounts payable as at year end*	

**Note: only monetary items are retranslated at the closing rate. Inventory goods are non-monetary items*

(c) Payment to Chinese supplier (5 February rate of exchange)

Debit Payable	€26,200
Debit Foreign Exchange Loss	€1,600
Credit Bank	€27,800
Being payment of supplier	

2. Difference between monetary and non-monetary assets and liabilities

2.1 ***Monetary Assets*** are Items that will be received in a fixed or determinable amount of cash, and include

- Cash
- Cash equivalents
- Debt securities
- Accounts receivable

2.2 ***Non-Monetary Assets*** are Items that will not be received in a fixed or determinable amount of cash, and include

- Inventory
- Prepaid expenses
- Equity Securities
- Investment Property
- Property, Plant and Equipment
- Intangible assets

2.3 ***Monetary Liabilities*** are Items that will be paid out in a fixed or determinable amount of cash, and include

- Accounts Payable
- Bonds Payable
- Leases Payable
- Accruals

2.4 ***Non-Monetary Liabilities*** are Items that will not be paid in a fixed or determinable amount of cash, and include

- Deferred Income
- Government Grants

Net Investment in a Foreign Operation:

An entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation. For example, the Government of Malta has a USD investment in the International Bank for Reconstruction and Development. Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation shall be recognized in surplus or deficit.

B. Reporting Foreign Currency Transactions in the Functional Currency

1. In preparing financial statements, each entity – whether a standalone entity, an entity with foreign operations (such as a controlling entity) or a foreign operation (such as a controlled entity or embassy) – determines its functional currency in accordance with section A above.

2. The entity translates foreign currency items into its functional currency and reports the effects of such translation in accordance with the following paragraphs.

3. Reporting Foreign Currency Transactions in the Functional Currency

3.1. Initial Recognition

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

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

3.2. 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.

3.2.1 The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with IPSASs.

3.3. Reporting at Subsequent Reporting Dates

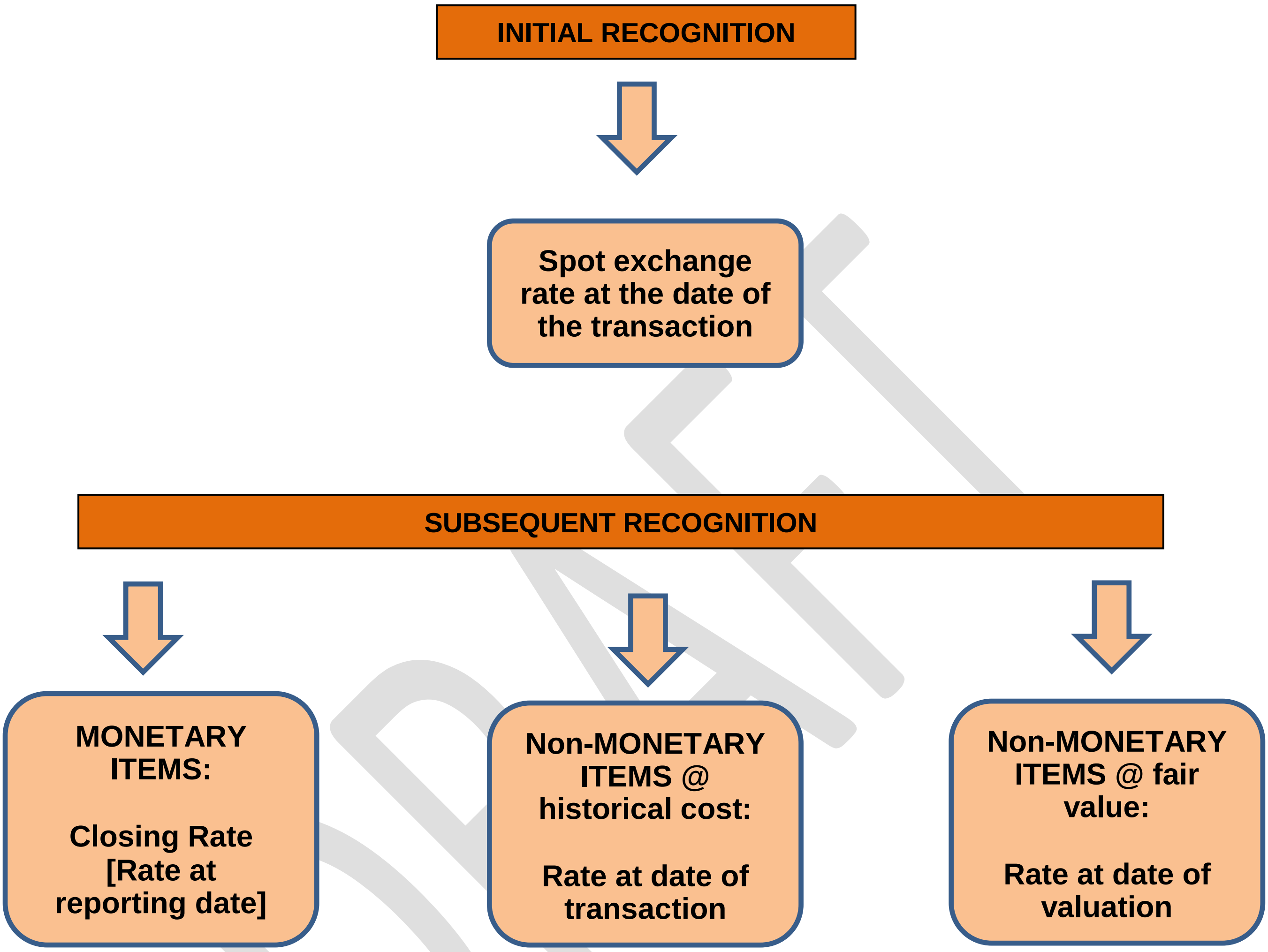
At each reporting date:

3.3.1 Foreign currency monetary items shall be translated using the closing rate;

3.3.2 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

3.3.3 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.

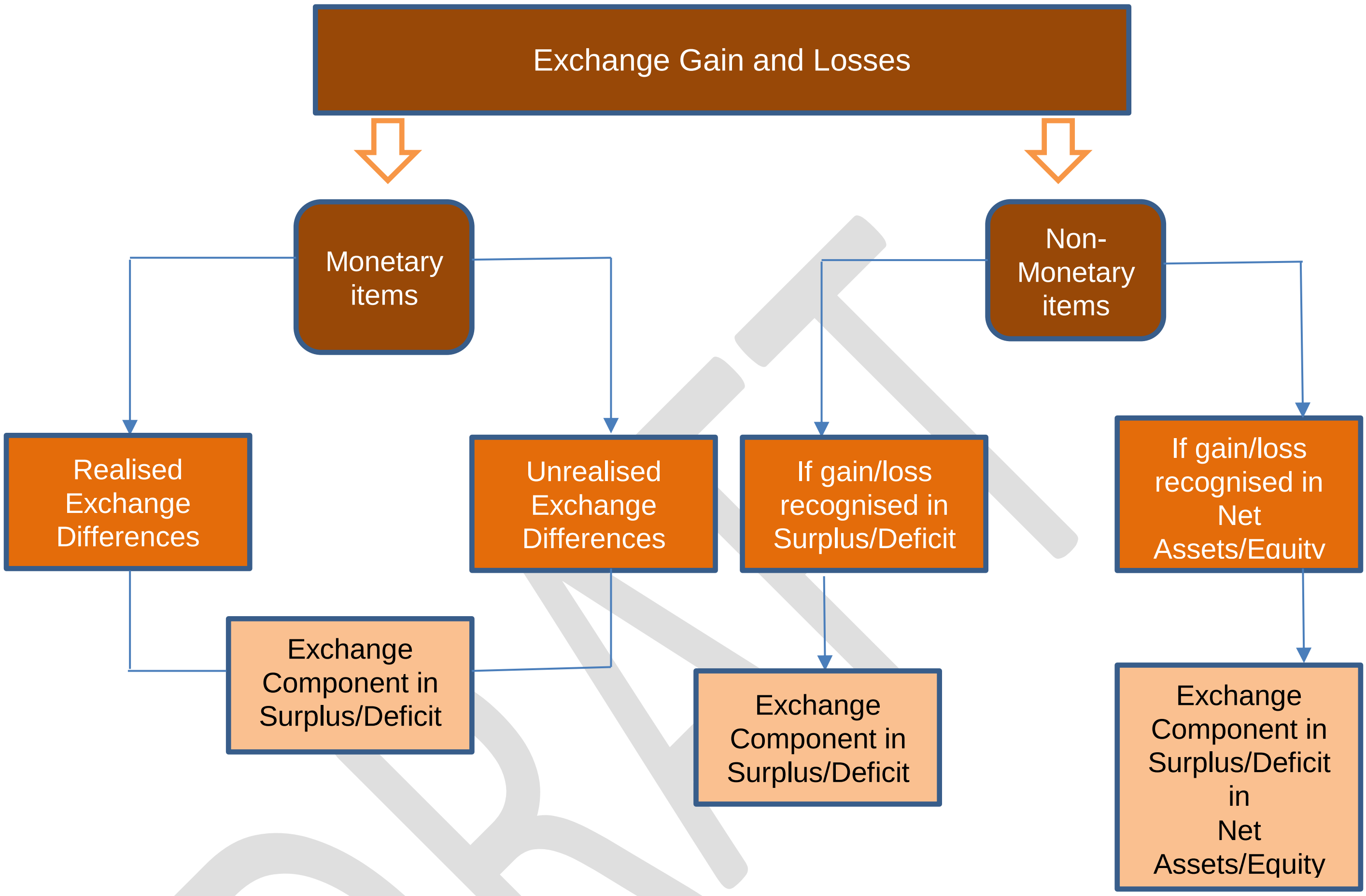
3.4. Therefore foreign currency transactions should initially be recorded at the spot rate of exchange at the date of the transaction. Subsequently, at each balance sheet date, foreign currency monetary amounts should be reported using the closing rate. Non-monetary items measured at historical cost should be reported using the exchange rate at the date of the transaction. Non-monetary items carried at fair value, however, should be reported at the rate that existed when the fair values were determined.



4. Recognition of Exchange Differences

4.1. 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 recognized in <u>surplus or deficit</u> in the period in which they arise.

4.2. When a gain or loss on a non-monetary item is recognized directly in net assets/equity, any exchange component of that gain or loss shall be recognized directly in <u>net assets/equity</u>. Conversely, when a gain or loss on a non-monetary item is recognized in surplus or deficit, any exchange component of that gain or loss shall be recognized in surplus or deficit. (E.g. IPSAS 17 requires some gains and losses arising on a revaluation of property, plant and equipment to be recognized directly in net assets/equity. When such an asset is measured in a foreign currency, the revalued amount is to be translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognized in net assets/equity).



5. Change in Functional Currency

5.1. When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency <u>prospectively</u> from the date of the change

5.2. An entity translates all items into the new functional currency using the exchange rate at the date of the change.

C. Use of a Presentation Currency Other than the Functional Currency

1. Translation to the Presentation Currency

1.1 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 financial performance and financial position into the presentation currency. For example, the embassies may present their financial statements in their currency, however these will need to be translated into Euros, the presentation currency.

<u>Hyperinflationary economy</u>: ministries and departments are to apply the parts of the standard that refer to the financial performance and financial position of an entity whose functional currency is **not** the currency of a hyperinflationary economy.

2. The financial performance and financial position of an entity shall be translated into a different presentation currency using the following procedures:

2.1 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;

2.2 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; and

2.3 All resulting exchange differences shall be recognized as a separate component of net assets/equity.

3. The exchange differences referred to in paragraph 2.3 result from:

3.1 Translating revenue 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 revenue and expense items recognized in surplus or deficit and on those recognized directly in net assets/equity.

3.2 Translating the opening net assets/equity at a closing rate that differs from the previous closing rate.

3.3 These exchange differences are not recognized in surplus or deficit because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations.

4. Translation of a Foreign Operation

4.1 In addition to paragraphs 1 to 3 above, the following shall apply when the financial performance and financial position of a foreign operation are translated into a presentation currency so that the foreign operation can be included in the financial statements of the reporting entity by consolidation, proportionate consolidation or the equity method.

4.2 The incorporation of the financial performance and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of balances and transactions within an economic entity.

4.3 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. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference continues to be recognized in surplus or deficit or, if it arises from the circumstances described in paragraph 37 of the standard, it is classified as net assets/equity until the disposal of the foreign operation

4.4 When the financial statements of a foreign operation are as of a date different from that of the reporting entity, the foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements. When this is not done, IPSAS allows the use of a different reporting date provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates.

4.5 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.

4.6 Adjustments are made for significant changes in exchange rates up to the reporting date of the reporting entity in accordance with IPSAS. The same approach is used in applying the equity method to associates and joint ventures and in applying proportionate consolidation to joint ventures.

4.7 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 paragraphs 44 and 48 of the standard.

5. Disposal of a Foreign Operation

5.1 On the disposal of a foreign operation, the cumulative amount of the exchange differences deferred in the separate component of net assets/equity relating to that foreign operation shall be recognized in surplus or deficit when the gain or loss on disposal is recognized.

D. Disclosure

1. Translation to the Presentation Currency

1.1 The entity shall disclose:

1.1.1 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 in accordance with the relevant international or national accounting standards dealing with the recognition and measurement of financial instruments; and

1.1.2 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.

1.2 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.

1.3 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.

1.4 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 International Public Sector Accounting Standards only if they comply with all the requirements of each applicable Standard including the translation method set out in paragraphs 44 and 48 of this Standard.

Glossary

“Closing rate’’ Closing rate is the spot exchange rate at the reporting date.

“Exchange difference’’ 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’’ Exchange rate is the ratio of exchange for two currencies.

‘‘Foreign currency’’ Foreign currency is a currency other than the functional currency of the entity.

“Foreign operation’’ Foreign operation is an entity that is a controlled entity, 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.

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

“Monetary items” 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.

“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/equity of that operation.

“Presentation currency” Presentation currency is the currency in which the financial statements are presented.

“Spot exchange rate” Spot exchange rate is the exchange rate for immediate delivery.