

## UNIT 3: ACCOUNTING STANDARD 11 THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

### LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the –

- ◆ Foreign Currency Transactions
  - Initial Recognition
  - Reporting at Subsequent Balance Sheet Dates
  - Recognition of Exchange Differences
- ◆ Net Investment in a Non-integral Foreign Operation
- ◆ Classification of Foreign Operations
  - Integral Foreign Operations
  - Non-integral Foreign Operations
  - Disposal of a Non-integral Foreign Operation
  - Change in the Classification of a Foreign Operation
  - Accounting for Forward Exchange Contracts
  - Disclosures



### 3.1 INTRODUCTION

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies (e.g., export sales in denominated in USD) or it may have foreign operations (e.g., foreign branch of reporting entity outside India). At the time of preparing the financial statements, these transactions and/or operations must be reported by the entity in the reporting currency i.e., INR. Hence, such foreign currency transactions and foreign operations should be translated into the reporting currency (i.e., INR) in order to be included in the financial statements of the entity.

The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognise the financial effects of changes in exchange rates in the financial statements.

### **Scope**

This Standard should be applied:

- (a) In accounting for transactions in foreign currencies.
- (b) In translating the financial statements of foreign operations.
- (c) This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

This Standard does not:

- (a) Specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, the Standard requires disclosure of the reasons for using that currency. The Standard also requires disclosure of the reason for any change in the reporting currency.

For example, all Indian companies are required to present their financial statements in INR. Thus, for such entities, INR is the reporting currency.

Alternatively, in case an Indian company is a subsidiary of a company located in the United States, the parent may require the company to present the financial statements in USD. In such cases, the company is required to disclose the reasons for presenting the financial statements in USD (a currency other than INR, the currency of the place where the company is domiciled i.e., India).

In both the cases discussed above, it may be pertinent to note that Accounting Standard 11 does not prescribe the currency to be used to present the financial statements. However, for all practical purposes (Income Tax Act, Indirect Tax Requirements etc.), every company domiciled in India will present financial statements in INR.

- (b) Deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation, which are addressed in AS 3 'Cash flow statement'.

- (c) Deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.
- (d) Deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

Considering the example above, the Indian subsidiary of the US Parent will present its financial statements in INR for the Indian regulators. However, since the US parent needs to consolidate the Indian subsidiary, it will require the Indian company to also restate the INR Financial Statements to USD. Such restatement is not covered under Accounting Standard 11.



## 3.2 DEFINITIONS OF THE TERMS USED IN THE STANDARD

**A foreign currency transaction** is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

- (a) Buys or sells goods or services whose price is denominated in a foreign currency.
- (b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.
- (c) Becomes a party to an unperformed forward exchange contract or
- (d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

**Monetary items** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables.

**Non-monetary items** are assets and liabilities other than monetary items. For example, fixed assets, advances for purchase of goods / fixed assets, inventories and investments in equity shares.

**Foreign operation** is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

**Integral foreign operation** is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations.

**Non-integral foreign operation** is a foreign operation that is not an integral foreign operation. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

'Net investment in a non-integral foreign operation' is the reporting enterprise's share in the net assets of that operation.

**Forward exchange contract** means an agreement to exchange different currencies at a forward rate.

**Forward rate** is the specified exchange rate for exchange of two currencies at a specified future date.

'Foreign currency' is a currency other than the reporting currency of an enterprise.

### 3.3 INITIAL RECOGNITION

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

A rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.



## 3.4 REPORTING AT EACH BALANCE SHEET DATE

The treatment of foreign currency items at the balance sheet date depends on whether the item is:

- monetary or non-monetary; and
  - carried at historical cost or fair value (for non-monetary items).
- (a) Foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from or required to disburse, such item at the balance sheet date.
- (b) Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.
- (c) Non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.
- (d) The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.



## 3.5 RECOGNITION OF EXCHANGE DIFFERENCES

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

An exchange difference results when there is a change in the exchange rate

between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

**Note:** Central Government in consultation with National Advisory Committee on Accounting Standards made an amendment to AS 11 “The Effects of Changes in Foreign Exchange Rates” in the form of Companies (Accounting Standards) Amendment Rules, 2009 and 2011.

According to the Notification, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortised over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods) but not beyond 31<sup>st</sup> March, 2020.

Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option should be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

If the above option is exercised, disclosure should be made of the fact of such exercise of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised.

For the purposes of exercise of this option, an asset or liability should be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

Further in December, 2011, the Ministry of Corporate Affairs inserted paragraph 46A in AS 11 of the Companies (Accounting Standards) Rules, 2006. According to it, in respect of accounting periods commencing on or after the 1<sup>st</sup> April, 2011, an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise, the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital assets, can be added to or deducted from the cost of the assets and should be depreciated **over the balance life of the assets**, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and **amortised over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods.**

Such option is irrevocable and should be applied to all such foreign currency monetary items. The enterprise exercising such option should disclose the fact of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised.



### 3.6 CLASSIFICATION OF FOREIGN OPERATIONS AS INTEGRAL OR NON-INTEGRAL

The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either 'integral foreign operations' or 'non-integral foreign operations'.

An integral foreign operation carries on its business as if it were an extension of the reporting enterprise's operations. For example, such an operation might only sell goods imported from the reporting enterprise and remits the proceeds to the

reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.



### 3.7 TRANSLATION OF FOREIGN INTEGRAL OPERATIONS

The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.





## 3.8 TRANSLATION OF NON-INTEGRAL FOREIGN OPERATIONS

The translation of the financial statements of a non-integral foreign operation is done using the following procedures:

- (a) The assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;
- (b) Income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and
- (c) All resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.
- (d) For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period is often used to translate income and expense items of a foreign operation.
- (e) Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate.
- (f) A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.
- (g) The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary. However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.
- (h) When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise (AS 21 (Revised)).

- (i) The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:
1. translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;
  2. translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and
  3. other changes to equity in the non-integral foreign operation.

These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

- (j) On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses.
- (k) An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. Remittance from a non-integral foreign operation by way of repatriation of accumulated profits does not form part of a disposal unless it constitutes return of the investment<sup>€</sup>. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognized at the time of a write-down".

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<sup>€</sup> MCA amended this paragraph, by notification dated 18<sup>th</sup> June, 2018, which is relevant for companies.

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

- (a) While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.
- (b) Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.
- (c) The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.
- (d) Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.
- (e) The foreign operation's sales are mainly in currencies other than the reporting currency.
- (f) Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.
- (g) Sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.
- (h) There is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

### Illustration 1

*Classify the following items as monetary or non-monetary item:*

*Inventories*

*Trade Receivables*

*Investment in Equity shares*

*Property, Plant and Equipment.*

**Solution**

Inventories	Non-monetary
Trade receivables	Monetary
Investment in equity shares	Non-monetary
Property, Plant and Equipment	Non-monetary

**Illustration 2**

	<b>Exchange Rate per \$</b>
<i>Goods purchased on 1.1.20X1 for US \$ 15,000</i>	₹ 75
<i>Exchange rate on 31.3.20X1</i>	₹ 74
<i>Date of actual payment 7.7.20X1</i>	₹ 73

You are required to ascertain the loss/gain to be recognized for financial years ended 31<sup>st</sup> March, 20X1 and 31<sup>st</sup> March, 20X2 as per AS 11.

**Solution**

As per AS 11 on 'The Effects of Changes in Foreign Exchange Rates', all foreign currency transactions should be recorded by applying the exchange rate on the date of transactions. Thus, goods purchased on 1.1.20X1 and corresponding creditors would be recorded at ₹ 11,25,000 (i.e. \$15,000 × ₹ 75)

According to the standard, at the balance sheet date all monetary transactions should be reported using the closing rate. Thus, creditors of US \$15,000 on 31.3.20X1 will be reported at ₹ 11,10,000 (i.e. \$15,000 × ₹ 74) and exchange profit of ₹ 15,000 (i.e. 11,25,000 – 11,10,000) should be credited to Profit and Loss account in the year ended 31<sup>st</sup> March, 20X1.

On 7.7.20X1, creditors of \$15,000 is paid at the rate of ₹ 73. As per AS 11, exchange difference on settlement of the account should also be transferred to Profit and Loss account. Therefore, ₹ 15,000 (i.e. 11,10,000 – 10,95,000) will be credited to Profit and Loss account in the year ended 31<sup>st</sup> March, 20X2.

**Illustration 3**

*Kalim Ltd. borrowed US\$ 4,50,000 on 01/01/20X1, which will be repaid as on 31/07/20X1. Kalim Ltd. prepares financial statement ending on 31/03/20X1. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:*

*01/01/20X1 1 US\$ = ₹ 48.00*

*31/03/20X1 1 US\$ = ₹ 49.00*

*31/07/20X1 1 US\$ = ₹ 49.50*

**Solution****Journal Entries in the Books of Kalim Ltd.**

Date	Particulars	₹ (Dr.)	₹ (Cr.)
20X1		216,00,000	
Jan. 01	Bank Account (4,50,000 x 48) Dr. To Foreign Loan Account		216,00,000
March 31	Foreign Exchange Difference Account Dr. To Foreign Loan Account [4,50,000 x (49-48)]	4,50,000	4,50,000
July 01	Foreign Exchange Difference Account Dr. [4,50,000 x (49.5-49)] Foreign Loan Account Dr. To Bank Account	2,25,000 220,50,000	2,22,75,000



### **3.9 CHANGE IN THE CLASSIFICATION OF A FOREIGN OPERATION**

When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve.

When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.



### 3.10 TAX EFFECTS OF EXCHANGE DIFFERENCES

Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22.



### 3.11 FORWARD EXCHANGE CONTRACT

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract.

Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

#### Illustration 4

*Rau Ltd. purchased a plant for US\$ 1,00,000 on 01<sup>st</sup> February 20X1, payable after three months. Company entered into a forward contract for three months @ ₹ 49.15 per dollar. Exchange rate per dollar on 01<sup>st</sup> Feb. was ₹ 48.85. How will you recognise the profit or loss on forward contract in the books of Rau Ltd.?*

**Solution**

Forward Rate	₹ 49.15
Less: Spot Rate	<u>(₹ 48.85)</u>
Premium on Contract	<u>₹ 0.30</u>
Contract Amount	US\$ 1,00,000
Total Loss (1,00,000 x 0.30)	₹ 30,000

Contract period 3 months (2 months falling in the year ended 31<sup>st</sup> March, 20X1)

Loss to be recognised  $(30,000/3) \times 2 = ₹ 20,000$  in the year ended 31<sup>st</sup> March, 20X1. Rest ₹ 10,000 will be recognised in the following year.

In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

**Illustration 5**

*Mr. A bought a forward contract for three months of US\$ 1,00,000 on 1<sup>st</sup> December at 1 US\$ = ₹ 47.10 when exchange rate was US\$ 1 = ₹ 47.02. On 31<sup>st</sup> December when he closed his books exchange rate was US\$ 1 = ₹ 47.15. On 31<sup>st</sup> January, he decided to sell the contract at ₹ 47.18 per dollar. Show how the profits from contract will be recognised in the books.*

**Solution**

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

Sale Rate	₹ 47.18
Less: Contract Rate	<u>(₹ 47.10)</u>
Premium on Contract	<u>₹ 0.08</u>
Contract Amount	US\$ 1,00,000
Total Profit (1,00,000 x 0.08)	₹ 8,000

### Illustration 6

*Assets and liabilities and income and expenditure items in respect of foreign branches (integral foreign operations) are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to the statement of profit and loss. Comment.*

### Solution

The financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures described in AS 11. The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. For practical reasons, a rate that approximates the actual rate at the date of transaction is often used, for example, an average rate for a week or a month may be used for all transactions in each foreign currency during the period. The foreign currency monetary items (for example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account. Exchange difference arising on the translation of the financial statement of foreign operation may have tax effect which should be dealt as per AS 22 'Accounting for Taxes on Income'.



Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11.

### Illustration 7

A business having the Head Office in Kolkata has a branch in UK. The following is the trial balance of Branch as at 31.03.20X4:

Account Name	Amount in £	
	Dr.	Cr.
Machinery (purchased on 01.04.20X1)	5,000	
Debtors	1,600	
Opening Stock	400	
Goods received from Head Office Account (Recorded in HO books as ₹ 4,02,000)	6,100	
Sales		20,000
Purchases	10,000	
Wages	1,000	
Salaries	1,200	
Cash	3,200	
Remittances to Head Office (Recorded in HO books as ₹ 1,91,000)	2,900	
Head Office Account (Recorded in HO books as ₹ 4,90,000)		7,400
Creditors		4,000

- Closing stock at branch is £ 700 on 31.03.20X4.
- Depreciation @ 10% p.a. is to be charged on Machinery.
- Prepare the trial balance after been converted in Indian Rupees.
- Exchange rates of Pounds on different dates are as follow:  
01.04.20X1– ₹ 61; 01.04.20X3– ₹ 63 & 31.03.20X4 – ₹ 67

**Solution**

**Trial Balance of the Foreign Branch converted into Indian Rupees as on March 31, 20X4**

<i>Particulars</i>	<i>£ (Dr.)</i>	<i>£ (Cr.)</i>	<i>Conversion Basis</i>	<i>₹ (Dr.)</i>	<i>₹ (Cr.)</i>
Machinery	5,000		Transaction date rate	3,05,000	
Debtors	1,600		Closing Rate	1,07,200	
Opening Stock	400		Opening Rate	25,200	
Goods Received from HO	6,100		Actuals	4,02,000	
Sales		20,000	Average Rate		13,00,000
Purchases	10,000		Average Rate	6,50,000	
Wages	1,000		Average Rate	65,000	
Salaries	1,200		Average Rate	78,000	
Cash	3,200		Closing Rate	2,14,400	
Remittance to HO	2,900		Actuals	1,91,000	
HO Account		7,400	Actuals		4,90,000
Creditors		4,000	Closing Rate		2,68,000
Exchange Rate Difference			Balancing Figure	20,200	
	31,400	31,400		20,58,000	20,58,000
Closing Stock	700		Closing Rate	46,900	
Depreciation	500		Fixed Asset Rate	30,500	



**3.12 DISCLOSURE**

An enterprise should disclose:

- (a) The amount of exchange differences included in the net profit or loss for the period.
- (b) Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

- (a) The nature of the change in classification;
- (b) The reason for the change;
- (c) The impact of the change in classification on shareholders' funds; and
- (d) The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.



### 3.13 PRESENTATION OF FOREIGN CURRENCY MONETARY ITEM TRANSLATION DIFFERENCE ACCOUNT (FCMITDA)

In the format of Schedule III to the Companies Act, 2013, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". Since the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Therefore, such balance cannot be reflected as an asset. Therefore, debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

#### Illustration 8

*A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.20X1 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 1.1.20X1 and 31.12.20X1 respectively. First instalment was paid on 31.12.20X1. The entire difference in foreign exchange has been capitalised.*

*You are required to state, how these transactions would be accounted for.*

**Solution**

As per AS 11 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognised as income or expense.

Calculation of Exchange Difference:

$$\text{Foreign currency loan} = \frac{\text{₹ 3,000 lakhs}}{\text{₹ 40}} = 75 \text{ lakhs US Dollars}$$

Exchange difference = 75 lakhs US Dollars × (42.50 – 40.00) = ₹187.50 lakhs (including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting ₹ 187.50 lakhs should be charged to profit and loss account for the year.

**Note:** The above answer has been given on the basis that the company has not exercised the option of capitalisation available under paragraph 46 of AS 11. However, if the company opts to avail the benefit given in paragraph 46A, then nothing is required to be done since the company has done the correct treatment.

**Illustration 9**

*A Ltd. has borrowed USD 10,000 in foreign currency on April 1, 20X1 at 5% p.a. annual interest and acquired a depreciable asset. The exchange rates are as under:*

*01/04/20X1 1 US\$ = ₹ 48.00*

*31/03/20X2 1 US\$ = ₹ 51.00*

*You are required to pass the journal entries in the following cases:*

- (i) Option under Para 46A is not availed.*
- (ii) Option under Para 46A is availed.*
- (iii) The loan was taken to finance the operations of the entity (and not to procure a depreciable asset).*

*In all cases, assume interest accrued on 31 March 20X2 is paid on the same date.*

## Solution

## Journal Entries in the Books of A Ltd.

## (i) Option under Para 46A is not availed

Date	Particulars	₹ (Dr.)	₹ (Cr.)
20X1			
Apr. 01	Bank Account (10,000 x 48) Dr. To Foreign Loan Account	4,80,000	4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x ₹ 51) To Bank Account	25,500	25,500
Mar 31	Foreign Exchange Difference Account (P/L) Dr. To Foreign Loan Account [10,000 x (51-48)]	30,000	30,000

In this case, since the option under Para 46A is **NOT** availed, the Exchange Loss of ₹ 30,000 is recognised as an expense in the Statement of Profit and Loss for the year ending 31 March 20X2.

## (ii) Option under Para 46A is availed

Date	Particulars	₹ (Dr.)	₹ (Cr.)
20X1			
Apr. 01	Bank Account (10,000 x 48) Dr. To Foreign Loan Account	4,80,000	4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x ₹ 51) To Bank Account	25,500	25,500
Mar 31	Foreign Exchange Difference Account Dr. To Foreign Loan Account [10,000 x (51-48)]	30,000	30,000
Mar 31	Property, Plant and Equipment Dr. To Foreign Exchange Difference Account	30,000	30,000

In this case, since the option under Para 46A is availed, the Exchange Loss of ₹ 30,000 is capitalized in the cost of Property, Plant and Equipment, which will indirectly get recognized in the Profit & Loss A/c by way of increased depreciation over the remaining useful life of the asset.

**(iii) Option under Para 46A is availed**

Date	Particulars	₹ (Dr.)	₹ (Cr.)
20X1			
Apr. 01	Bank Account (10,000 x 48) Dr. To Foreign Loan Account	4,80,000	4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x ₹ 51) To Bank Account	25,500	25,500
Mar 31	Foreign Exchange Difference Account Dr. To Foreign Loan Account [10,000 x (51-48)]	30,000	30,000
Mar 31	Foreign Currency Monetary Item Translation Difference A/c (FCMITDA) Dr. To Foreign Exchange Difference Account	30,000	30,000

In this case, since the option under Para 46A is availed, the Exchange Loss of ₹ 30,000 is accumulated in the FCMITD A/c, which will be subsequently spread over and debited to P&L A/c over the tenure of the loan.

**Reference:** The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates".

## TEST YOUR KNOWLEDGE

### Multiple Choice Questions

1. *As per AS 11 assets and liabilities of non-integral foreign operations should be converted at \_\_\_\_\_ rate.*
  - (a) *Opening*
  - (b) *Average*
  - (c) *Closing*
  - (d) *Transaction*
2. *The debit or credit balance of "Foreign Currency Monetary Item Translation Difference Account"*
  - (a) *Is shown as "Miscellaneous Expenditure" in the Balance Sheet*
  - (b) *Is shown under "Reserves and Surplus" as a separate line item*
  - (c) *Is shown as "Other Non-current" in the Balance Sheet*
  - (d) *Is shown as "Current Assets" in the Balance Sheet*
3. *If asset of an integral foreign operation is carried at cost, cost and depreciation of tangible fixed asset is translated at*
  - (a) *Average exchange rate*
  - (b) *Closing exchange rate*
  - (c) *Exchange rate at the date of purchase of asset*
  - (d) *Opening exchange rate*
4. *Which of the following can be classified as an integral foreign operation?*
  - (a) *Branch office serving as an extension of the head office in terms of operations*
  - (b) *Independent subsidiary of the parent company*

- (c) Branch office independent of the head office in terms of operational decisions
  - (d) None of the above
5. Which of the following items should be converted to closing rate for the purposes of financial reporting?
- (a) Items of Property, Plant and Equipment
  - (b) Inventory
  - (c) Trade Payables, Trade Receivables and Foreign Currency Borrowings
  - (d) All of the above

**Theoretical Questions**

- 6. Explain “monetary item” as per Accounting Standard 11. How are foreign currency monetary items to be recognized at each Balance Sheet date?
- 7. Distinguish Non-Integral Foreign Operation (NFO) with Integral Foreign Operation (IFO) as per AS 11.

**Scenario based Questions**

- 8. Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3. 20X1.

Trade receivables include amount receivable from Umesh ₹ 5,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US \$ 1 = ₹58.50.

Long term loan taken from a U.S. Company, amounting to ₹ 60,00,000. It was recorded at US \$ 1 = ₹ 55.60, taking exchange rate prevailing at the date of transaction. US \$ 1 = ₹61.20 was on 31.3. 20X1.

**ANSWERS/SOLUTION**

**Answer to the Multiple Choice Questions**

1.	(c)	2.	(b)	3.	(c)	4.	(a)	5.	(c)		
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## Answer to the Theoretical Questions

6. As per AS 11 'The Effects of Changes in Foreign Exchange Rates', Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Foreign currency monetary items should be reported using the closing rate at each balance sheet date. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realized from, or required to disburse, a foreign currency monetary item at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to disburse, such item at the balance sheet date.

7. As per AS 11, Integral foreign operation (IFO) is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. In contrast, a non-integral foreign operation (NFO) is a foreign operation that is not an integral operation. For details, refer para 2.5 of chapter.

## Answer to the Scenario based Questions

8. As per AS 11 "The Effects of Changes in Foreign Exchange Rates", exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

However, at the option of an entity, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or

reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortised over the balance period of such long-term asset/liability, by recognition as income or expense in each of such periods.

<b>Trade receivables</b>	<b>Foreign Currency Rate</b>	<b>₹</b>
Initial recognition US \$ 8,547 (5,00,000/58.50)	1 US \$ = ₹ 58.50	5,00,000
Rate on Balance sheet date	1 US \$ = ₹ 61.20	
Exchange Difference Gain US \$ 8,547 X (61.20-58.50)		23,077
Treatment: Credit Profit and Loss A/c by ₹ 23,077		
Long term Loan		
Initial recognition US \$ 1,07,913.67 (60,00,000/55.60)	1 US \$ = ₹ 55.60	60,00,000
Rate on Balance sheet date	1 US \$ = ₹ 61.20	
Exchange Difference Loss US \$ 1,07,913.67 X (61.20 – 55.60)		6,04,317
Treatment: Credit Loan A/c And Debit FCMITD A/C or Profit and Loss A/c by ₹ 6,04,317		

Thus Exchange Difference on Long term loan amounting ₹ 6,04,317 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on debtors amounting ₹ 23,077 is required to be transferred to Profit and Loss A/c.