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INDIAN ACCOUNTING STANDARDS AND THEIR CONVERGENCE TO IFRS

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THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES - IAS 21

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ABSTRACT

International Accounting Standard (IAS) 21, The Effects of Changes in Foreign Exchange Rates, prescribes the accounting treatment for the transactions denominated in a foreign currency. In December 1977, the International Accounting Standards Committee (IASC) issued the Exposure Draft E11, Accounting for Foreign Transactions and Translation of Foreign Financial Statements. In March 1982, the Exposure Draft E11 was modified and re-exposed as Exposure Draft E23, Accounting for the Effects of Changes in Foreign Exchange Rates. In December 1993, the IASC issued IAS 21, The Effects of Changes in Foreign Exchange Rates, effective from January 1, 1995. In December 2005, the IASB issued Minor Amendment to IAS 21 relating to net investment in a foreign operation. The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 21 is AS 11, The Effects of Changes in Foreign Exchange Rates. The major differences between these two standards are difference due to level of only preparedness. This paper revisits the convergence of AS11 with IAS 21 and tries to explain its effects on the financial statements for organizations and practitioners and highlights certain aspects of putting foreign exchange accounting into practice.

KEY WORDS:

IAS 21 , AS 11, Foreign Exchange, International Accounting Standards Committee, Foreign Exchange Rates,

INTRODUCTION

IFRS -now a truly global standard

- IFRS is adopted in more than 100 countries
- The IFRS movement started in India in the year 2001
- ICAI presented Position paper in the year 2007 and issued concept paper in 2009
- Due to the announcement in government policy as to adopt IFRS from 1 April 2007, all regulatory procedures were fastened to implement IFRS in India
- By 2011, more than 150 countries have adopted IFRS including India, China, Brazil and Korea
- IFRS includes IAS: International Accounting standards, SIC: Standard of interpretation committee, IFRS: International financial reporting standards, IFRIC: International Financial reporting Interpretation committee.

International Accounting Standard (IAS) 21, The Effects of Changes in Foreign Exchange Rates, prescribes the accounting treatment for the transactions denominated in a foreign currency. In December 1977, the International Accounting Standards Committee (IASC) issued the Exposure Draft E11, Accounting for Foreign Transactions and Translation of Foreign Financial Statements. In March 1982, the Exposure Draft E11 was modified and re-exposed as Exposure Draft E23, Accounting for the Effects of Changes in Foreign Exchange Rates. In July 1983, the IASC issued IAS 21, Accounting for the Effects of Changes in Foreign Exchange Rates, effective from January 1, 1985.

In 1993, the IAS 21 (1983) was revised as part of the Comparability of Financial Statements' project based on E32. In May 1992, the IASC issued the Exposure Draft E44, The Effects of Changes in Foreign Exchange Rates. In December 1993, the IASC issued IAS 21, The Effects of Changes in Foreign Exchange Rates, effective from January 1, 1995. On December 18, 2003, the International Accounting Standards Board (IASB) issued the revised version of IAS 21, effective from January 1, 2005. In December 2005, the IASB issued Minor Amendment to IAS 21 relating to net investment in a foreign operation. The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) **comparative to IAS 21 is AS 11**, The Effects of Changes in Foreign Exchange Rates. The major differences between these two standards are difference due to level of only preparedness.

OBJECTIVES OF THE STUDY

The primary goal of this study is to understand the basis for selecting an entity's functional currency and the accounting treatment for the recognition of, and subsequent measurement of, transactions denominated in a foreign currency and the process of translating financial statements denominated in a foreign currency.

The secondary objectives are

To understand the provisions of IAS 21.

To study Indian accounting Standard 11 and its convergence with IAS 21.

To create awareness amongst various stakeholders and citizens about the framework of IAS21.

LIMITATION:

This study is based on the secondary data collected from corporate, Annual reports of various industrial houses, Journals, websites and periodicals. The study is further limited to the discussion of the need of Carbon Credit Accounting framework for corporate sustainability.

HYPOTHESIS

The postponement of AS 11 to 2011 raised serious questions about the India's convergence with IAS

METHODOLOGY

This study is based on **secondary data's**. The information has been collected from authorities of the corporate, annual reports, journals and periodicals.

Statement and Significance

Scope and Application of IAS 21 : It is applicable to :-

- Accounting for transactions and balances in foreign currencies except for derivatives.
- Translating the results and financial position of foreign operations.
- Translating entity's results and financial position into a presentation currency.

But IAS 21 does not apply to hedge accounting for foreign currency items and to foreign currency derivatives that are within the scope of IAS 39.

IAS 21 does not apply to the presentation in a cash-flow statement of cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation (IAS 7, Statement of Cash Flows).

Prescribed Accounting Treatment

Transactions

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

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

All transactions are recognized in the functional currency of the entity. All currencies other than the functional currency are foreign currencies. A legal or economic entity may have more than one functional currency if it has a foreign operation (subsidiary, associate, joint venture or branch with activities based or conducted in a different country or currency).

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. The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with International Financial Reporting Standards (IFRS). For practical reasons, 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 inappropriate.

At subsequent reporting dates, any foreign currency denominated monetary items are remeasured using the closing rate. Where any non-monetary items arising from transactions denominated in a foreign currency are subsequently remeasured to fair value, the remeasured amounts are translated using the exchange rate at the date of remeasurement.

When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.

Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognised or in previous financial statements are reported in profit or loss in the period, with one exception. The exception is that exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised, in the consolidated financial statements that include the foreign operation, in a separate component of equity; they will be recognised in profit or loss on disposal of the net investment.

Loan receivable from and payable items to a foreign operation shall be included in the net investment in a foreign operation, if the settlement is neither planned nor likely to occur.

If a gain or loss on a non-monetary item is recognised directly in equity (for example, a property revaluation under IAS 16), any foreign exchange component of that gain or loss is also recognised directly in equity.

Translation

An entity may elect to present its financial report in any currency (referred to as the presentation currency). For this purpose, an entity could be a standalone entity, a parent preparing consolidated financial statements or a parent, an investor or a venture preparing separate financial statements in accordance with IAS 27, Consolidated and **Separate Financial Statements**. For operations where the functional currency is not the presentation currency, assets and liabilities are translated to the presentation currency using the closing rate at reporting date and income and expenses are translated using the exchange rate at the transaction date. Any resulting exchange difference is recognised as a separate component of equity (e.g. debit or credit to equity). For groups, translation of each entity within the group to the group's presentation currency is performed before preparing the consolidated financial report. A similar process is also adopted in an individual entity's financial report where, for example, there is a branch operation with a different functional currency.

Determination of Functional Currency

The functional currency of an entity depends on the primary economic environment, which is normally the environment in which the entity primarily generates and expends cash*.

An entity considers the following factors in determining its functional currency:

(a) the currency:

- (i) that mainly influences selling prices for goods and services (this will often be the currency in which selling prices for its goods and services are denominated and settled); and
- (ii) of the main country whose competitive forces and regulations determine the selling prices of its goods and services.

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

Tax Effects of all Exchange Differences

Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. IAS 12, Income Taxes applies to these tax effects.

Prescribed Disclosures

Required disclosures include:

- Exchange differences recognized in profit or loss (excluding those for financial instruments measured at fair value through profit and loss under IAS 39)
- Net exchange differences classified in a separate component of equity, reconciling the amount at the beginning and end of the period
- If the presentation currency is not the functional currency, that fact shall be stated with the disclosure of the functional currency, and the reason for using a different presentation currency
- Where there is a change in functional currency, the fact and reason for the change in functional currency shall be disclosed
- when an entity presents its financial statements in a currency that is different from its functional currency, the financial statements shall be described as complying with IFRS only if they comply with all requirements of standards and interpretations

Minor Amendment to IAS 21 – Net Investment in a Foreign Operation

In June 2005 Meeting, the IASB discussed whether different accounting treatments should apply to exchange differences on monetary items denominated in different currencies. The IASB also discussed whether funding provided to a foreign operation by a group entity that is not the reporting entity may be considered to be part of the reporting entity's net investment in that foreign operation in the context of paragraph 32 of IAS 21.

The IASB agreed that the intention should be to treat third-currency denominated monetary items that form a part of the net investment in a foreign operation similar to when the monetary item is denominated in the functional currency of either the reporting entity or the foreign operation.

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 21 is AS 11, The Effects of Changes in Foreign Exchange Rates. The major differences between these two standards are difference due to level of preparedness:

1. AS 11 is based on the integral and non-integral foreign operations approach, i.e., the approach which was followed in the earlier IAS 21.
2. The current IAS 21, which is based on 'Functional Currency' approach, gives similar results as that under pre-revised IAS 21, which was based on integral /non-integral Foreign operations approach. Accordingly, there are no significant differences between IAS 21 and AS 11.

Indian companies, which were hit by both the rapid appreciation and depreciation of foreign currencies, had demanded for the suspension of the provisions of AS 11 that require recognizing foreign exchange losses in the financial statements. The Confederation of Indian Industry (CII), the

Federation of Indian Chambers of Commerce and Industry (FICCI) and ASSOCHAM have been demanding the postponement of the implementation of AS 11 because several companies with foreign exchange earnings will have to take a hit on their profits because the rupee has depreciated by over 25% in the past one year.

On March 24, 2009, the National Advisory Committee on Accounting Standard (NACAS) has postponed the implementation of AS 11 to 2011 after the conclusion of the meeting to take up the matter of how companies should account for foreign exchange losses or gains caused by a wildly swinging Rupee.

On March 31, 2009, the Ministry of Corporate Affairs (MCA) notified in the Official Gazette, the Companies (Accounting Standards) Amendment Rules, 2009 for introducing an additional paragraph 46 to AS 11. The rules provide certain Amendments.

The above amendment shall be applicable to corporates registered under the Companies Act, 1956 and all non-corporate entities, partnership or otherwise, are still expected to Comply with AS 11 as pronounced by the ICAI.

CONCLUSIONS-

In the current scenario where various countries are moving towards IFRS, India has also decided to converge with IFRS. For this purpose, the Institute of Chartered Accountants of India (ICAI) is actively engaged in formulation of IFRS-converged Indian Accounting Standards (Ind ASs).

AS 11 dealt with mark-to-market provisioning in corporate profit and loss accounts for Foreign exchange related gains and losses. The suspension of AS 11 results domestic Firms have the option not to provide for foreign exchange losses or gains till 2011. The postponement of AS 11 to 2011 raises serious questions about the India's convergence with IFRS in 2011.

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