

## ACCOUNTING STANDARD – 11 “EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES”

“The Pessimist Sees Difficulty in Every Opportunity. The Optimist Sees Opportunity in Every Difficulty.”

### THIS AS DEALS WITH: -

- Treatment of Foreign Currency Transactions
- Translation of Financial Statements of Foreign Operations (Branch/Subsidiary)
- Forward Exchange Contracts. (Hedge and Speculation)

## 1. FOREIGN CURRENCY TRANSACTIONS

### 1.1 DEFINITIONS

**Currencies** - For the purpose of this AS, there are two types of Currencies

- (a) **Reporting Currency** - Any Currency in which Financial Statements are reported.
- (b) **Foreign Currency** - Any Currency other than Reporting currency.

**A Foreign Currency Transaction** is a transaction which is denominated in or requires settlement in a foreign currency for example - sale or purchase of goods in Foreign Currency, Borrowings or Lending or Investing in Foreign Currencies etc.

**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, inventories and investments in equity shares.

**Foreign Currency Monetary Items** are Monetary Items which are to be settled in Foreign Currency (i.e., Receivable or Payable in Foreign Currency)

## 1.2 RECOGNITION AND MEASUREMENT

Two important questions?

### Q1. What is Initial Recognition?

Initial Recognition means first time recording in the books of accounts of Foreign Currency Transaction.

### Q2. What is Subsequent measurement?

Subsequent Measurement means measurement at Balance Sheet date of Foreign Currency Monetary Items (FCMI) arising out of Foreign Currency Transactions.

**Initial Recognition:** All foreign exchange transactions are converted into reporting currency using Spot exchange rate or approximate rates (i.e., the exchange rate prevailing on the date of Transaction).

**Examples of Foreign Currency Transactions:**

- Buying or selling of Goods and Services in Foreign Currency;
- Borrowing or Lending Money in Foreign Currency;
- Acquisition or Disposal of Assets in Foreign Currency;
- Incurring or Settling any Liability in Foreign Currency

**Subsequent Measurement (at BS date):**

- This recognition is applied on Foreign currency Monetary Items (FCMI) and Non-Monetary Items carried at fair value or measured at other than cost.
- Subsequent measurement is applied for preparing financial statements.
- Any exchange difference arising on subsequent measurement at Balance Sheet date shall be transferred to Profit & Loss a/c.

S.NO.	Financial Statement Items	Exchange Rates
1	Monetary Items i.e. FCMI (e.g., Foreign Receivables or Payables)	Exchange Rate <b>at the Reporting Date</b> (i.e., Closing Exchange Rate)
2	Non-Monetary items at historical cost (e.g., PPE)	Exchange Rate at <b>the date of transaction</b> (i.e., Spot Rate)
3	Revalued Non-monetary items or Items Measured at Fair Value (E.g., Inventory, Investments in Equity Shares)  <b>Refer Example No 3</b>	Exchange Rate at the <b>date of Fair valuation or Revaluation</b>  <b>Example:</b> the cost or carrying amount, as appropriate, is translated at the exchange rate at the date when that amount was determined; and the net

		realisable value or recoverable amount, as appropriate, is translated at the exchange rate at the date when that value was determined.
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**Note:** Foreign Currency Monetary Items (FCMI): FCMI are those Assets/Liabilities whose amount is Fixed under contract and they are to be settled in foreign currency. For example, Receivable, Payables, Cash Balances.

### Example 1:

Mr. A Purchased Goods of \$30,000 on 1/Feb for which payment to be made in next year 30/4

**Issue 1:** How to record on 1/Feb because it is in \$

**Issue 2:** What to do on Balance Sheet Date i.e., 31/3 because \$ Changes

**Issue 3:** on 30/4 Settlement is in \$ the how to Measure?

### Solution:

#### Issue 1:

As per AS 11, all Foreign Currency transaction must be recorded at the rate prevailing on transaction Date (i.e. SPOT Rate)

Suppose 1<sup>st</sup> Feb \$1 = 76/-

Transaction Vale = \$30,000 × 76 = 22,80,000/-

1<sup>st</sup> Feb:

Purchase A/c	Dr.	22,80,000	
To Foreign Creditor A/c			22,80,000

#### Trading A/c

To Purchases	22,80,000		
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#### Balance Sheet

Foreign Creditors (\$30,000)	22,80,000		
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#### Issue 2:

On 31<sup>st</sup> March \$1 = ₹ 77

As per AS 11, All Monetary Assets/Liabilities which are in foreign Currency (FCMI) should be measured at Closing Exchange Rate on Balance Sheet Date.

Revised Foreign Creditors = \$30,000 × 77 = 23,10,000

Exchange Difference (Loss) = 23,10,000 - 22,80,000 = 30,000

31/3

Exchange Loss A/c	Dr.	30,000	
To Foreign Creditor A/c			30,000

As per AS 11, Exchange Difference due to measurement of FCMI should be transfer to P&L A/c 31/3

P&L A/c	Dr.	30,000	
To Exchange Loss A/c			30,000

### Trading A/c

To Purchases	22,80,000		
To Exchange Loss	30,000		

### Balance Sheet

Foreign Creditors (\$30,000)	23,10,000		
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### Issue 3:

At the time of settlement \$ again Change to ₹ 77.80

Amount to be paid in ₹ = \$30,000 × 77.80 = 23,34,000/-

30/4

Foreign Creditors A/c	Dr.	23,10,000	
Exchange Loss A/c	Dr.	24,000	
To Bank A/c			23,34,000

As per AS 11, Exchange Difference at settlement shall be transferred to P&L A/c

### Example 2:

On 1<sup>st</sup> Feb, Entity purchased PPE at \$25,000 & Paid immediately

\$1 = ₹ 76 (on 1<sup>st</sup> Feb)

\$1 = ₹ 77 (on 31/3)

Apply AS 11.

### Solution:

As per AS 11, all foreign Currency Transaction must be recorded & measured at the rate prevailing on transaction date. (SPOT Rate)

Transaction Value in ₹ = \$25,000 × 76 = 19,00,000/-

PPE A/c		19,00,000	
Dr.			19,00,000
To Bank A/c			

Note: No Subsequent Measurement is required if PPE is measured under Cost Model.

### Example 3: (Subsequent Measurement of Foreign Currency Non-Monetary Item)

Inventory purchased costing \$10,000 in cash as 1/4/23. On 30<sup>th</sup> June inventory is unsold.

Case 1: NRV is \$12,000 on 30<sup>th</sup> June

Case 2: NRV is \$ 9000 on 30<sup>th</sup> June & it is measured on 10<sup>th</sup> July

Rate of \$1 on 1/4/23 = ₹80, on 30<sup>th</sup> June \$1 = ₹ 82/- and on 10<sup>th</sup> July \$1 = ₹ 82.5/-

### Solution:

#### 1) Initial recognition of Foreign Currency Transaction

Cost of Acquisition = \$10,000 × 80/- = Rs. 8,00,000

01/04/23	Purchase a/c Dr	8,00,000
	To Bank a/c	8,00,000

#### 2) Subsequent measurement on 30<sup>th</sup> June (BS Date)

Case 1:

Cost = \$10,000

NRV = \$12,000

Since Cost is Lower, It is a non-monetary item measured at cost.

Conclusion:

No need to remeasure at New Ex Rate, it should be Continued at Historical Rate.

Balance Sheet	
Inventory (\$10000)	8,00,000

Case 2: Cost = \$10,000; NVR = \$ 9000

Therefore, Inventory is non-monetary item, measured at other than cost.

As per AS 11, this is to be measured at Exchange Rate on the date of Valuation of NRV i.e 10<sup>th</sup> July = \$1 = Rs. 82.50/-

Total Inventory value = \$9000 × 82.5/- = Rs. 7,42,500/-

Trading a/c		
	Debit	Credit
Purchase	8,00,000	Closing stock 742500

## PARA 46 OF AS 11 ON TREATMENT OF LONG TERM FOREIGN CURRENCY MONETARY ITEMS UNDER SUBSEQUENT MEASUREMENT

Para 46 has been introduced in AS 11 with retrospective effect from 7<sup>th</sup> December 2006 amended on 31<sup>st</sup> March, 2009.

- Corporate/Non-Corporate entities can opt for the application of this Para & option is irrevocable.
- FCMI of Long Term in nature (whose realization/payment is beyond 12 months from the date of original transaction) will be converted using closing rate in subsequent recognition.

**Exchange difference arising from above point will be recognized as follows:**

- Transfer Exchange difference to value of Depreciable Fixed Assets (PPE) if long term monetary item was taken to finance such Depreciable F.A. (i.e., to be capitalized if debit difference and subtracted if credit difference) (Refer Example No. 4)

- Transfer Exchange difference to Foreign Currency Monetary Items Translation Diff a/c (FC MIT Diff a/c) if Long Term Monetary Item has no relation with Depreciable Fixed Assets. (Refer Example No. 5)
- FC MIT Diff a/c will be amortised over the balance period of such long-term assets or liability, by recognition as income or expense in each of such periods (written off in periods equally till the life of LTFCMI.)
- The balance in FC MIT Diff a/c (debit or credit) should be shown on the "Equity and Liabilities" side of the balance sheet under the head "Reserves and Surplus" as a separate line item. (as decided by the council of ICAI)

**Example 4:**

Vsmart Ltd. took a Foreign Currency Loan of \$1,00,000 to purchase machine of the same amount. On 1<sup>st</sup> April, 2022 Loan is of 5Years. To be repaid in lumpsum after 5 Years.

Depreciation Rate is 10%

Exchange rates are as follows:

On 1/4/22 - \$1 = ₹ 78

On 31/3/23 - \$1 = ₹ 82

On 31/3/24 - \$1 = ₹ 80.5

Show A/c as per AS 11 in following cases:

(a) Without PARA 46

(b) With PARA 46

**Solution:****1) Initial Recognition:**

Foreign Currency should recognise at the rate prevailing on transaction Date (i.e. SPOT Rate) i.e. \$1 = ₹ 78

Transaction Value = \$1,00,000 × 78 = 78,00,000

1/4/22

Machine A/c	Dr.	78,00,000	
To Foreign Currency Loan A/c			78,00,000

(Note: assuming machine is measured at cost always)

(Note: Foreign Currency Loan is a LTFCMI)

**2) Subsequent measurement:****Case 1: without PARA 46**

Exchange Difference due to Subsequent measurement shall be transfer to Profit & Loss A/c

1<sup>st</sup> Year end: 31/3/23

Foreign Currency Loan Should be = \$1,00,000 × 82 = 82,00,000

Exchange Difference (Loss) = 4,00,000

31/3/23

Exchange Difference (P&L) A/c Dr. To Foreign Currency Loan A/c		4,00,000	4,00,000
Profit & Loss A/c To Exchange Difference A/c	Dr.	4,00,000	4,00,000

2<sup>nd</sup> Year end: 31/3/24

Foreign Currency Loan Should be = \$1,00,000 × 80.5 = 80,50,000

Exchange Difference (Gain) = 82 - 80.5 = 1,50,000

Foreign Currency Loan A/c To Exchange Difference (P&L) A/c	Dr.	1,50,000	1,50,000
Exchange Difference (Gain) A/c Dr. To Profit & Loss A/c		1,50,000	1,50,000

**Case 2: with PARA 46**

Exchange Difference should be adjusted to the cost of machine

31/3/23

Exchange Difference (Loss) = 4,00,000

Machine A/c To Foreign Currency Loan A/c	Dr.	4,00,000	4,00,000
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Depreciation @10% = 82,00,000 × 10% = 8,20,000

Remaining Balance of Machine = 73,80,000

31/3/24

Exchange Difference (Gain) = 1,50,000

Deduct From Machines Book Value

Foreign Currency Loan A/c To Machine A/c	Dr.	1,50,000	1,50,000
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Depreciation @10% on (73,80,000 - 1,50,000) = 72,30,000 × 10% = 7,23,000

**Example 5:**

Vsmart Ltd. took a loan of \$75,000 on 1/4/22 when \$1 = ₹ 78. Loan is utilized for working capital requirement loan is of 6 Years. Principal repayment equally every year.

1<sup>st</sup> year end - \$1 = ₹ 81.302<sup>nd</sup> year end - \$1 = ₹ 82.153<sup>rd</sup> year end - \$1 = ₹ 824<sup>th</sup> year end - \$1 = ₹ 81.505<sup>th</sup> year end - \$1 = ₹ 81.906<sup>th</sup> year end - \$1 = ₹ 82

Apply PARA 46 of AS 11:

**Solution:****1) Initial Recognition:**

Bank A/c	Dr.	58,50,000	
To Foreign Currency Loan A/c			58,50,000

**2) Subsequent Measurement:**

31/3/23 (Fist remeasure then pay installment)

FCMIT Difference A/c		2,47,500	
Dr.			2,47,500
To FC Loan A/c (\$75,000 × 3.30)			
FC Loan A/c	Dr.	10,16,250	
To Bank A/c (\$12,500 × 81.30)			10,16,250

Foreign Currency Book Value = 50,81,250

Amortize FCMIT Difference in 6 Years = 2,47,500 / 6 = 41,250

Profit & Loss A/c	Dr.	41,250	
To FCMIT Difference A/c			41,250

Balance unamortised FCMIT = 2,06,250 (Dr. Balance)

31/3/24	31/3/25	31/3/26	31/3/27	31/3/28
\$1 = ₹ 82.15	\$1 = ₹ 82	\$1 = ₹ 81.50	\$1 = ₹ 81.90	\$1 = ₹ 82
Prev. rate = 81.30	Prev. rate = 82.15	Prev. rate = 82	Prev. rate = 81.50	Prev. rate = 81.90
Loss = 0.85 × \$62,500	Gain = 0.15 × \$50,000	Gain = 0.5 × \$37,500	Loss = 0.4 × \$25,000	Loss = 0.10 × \$12,500
Total Loss = 53,125	Total Gain = 7,500	Total Gain = 18,750	Total Loss = 10,000	Total Loss = 1,250
Loss added to FCMIT Difference	Deduct from FCMIT Difference	Deduct from FCMIT Difference	Added to FCMIT Difference	Added to FCMIT Difference
Revised FCMIT Difference = 2,59,375	Revised FCMIT Difference = 2,00,000	Revised FCMIT Difference = 1,31,250	Revised FCMIT Difference = 97,500	Revised FCMIT Difference = 50,000
Year = 5	Year = 4	Year = 3	Year = 2	Year = 1
P&L A/c = 51,875	P&L A/c amortised = 50,000	P&L A/c amortised = 43,750	P&L A/c amortised = 48,750	Fully amortised to P&L A/c = 50,000
Closing Balance of FCMIT = 2,07,500	Closing Balance of FCMIT = 1,50,000	Closing Balance of FCMIT = 87,500	Closing Balance of FCMIT = 48,750	

## 2. TRANSLATION OF FINANCIAL STATEMENTS OF FOREIGN OPERATIONS

AS 11 (Effect of Changes in Foreign Exchange Rates), classifies the foreign branches as:

- **INTEGRAL FOREIGN OPERATION:** The activities of which are an integral part of those of the reporting enterprise (i.e. Head Office). An integral foreign operation carries on its business as if it were an extension of the reporting enterprise's operations. (Example - Foreign Branch)
- **NON-INTEGRAL FOREIGN OPERATION:** The business of such branch is carried on in a substantially independent way. (Example - Foreign Subsidiary Co.)  
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.

### TECHNIQUES FOR TRANSLATION:

#### (A) Integral Foreign Branch:

Items to be Translated	Translation at
Monetary Items (such as Debtors/creditors, Cash/Bank, Prepaid/Outstanding expense)	At Closing exchange rate
Non-Monetary items (such FA, Accumulated depreciation on FA, Investments etc.)	At Cost i.e., at the exchange rate on the date of purchase
Opening Stock	Opening exchange rate
Closing Stock	Closing exchange rate
Revenue nature items (Incomes and expenses)	Average rate
Goods sent to branch a/c and HO a/c	Actual balance in HO books

Any Exchange difference arising on the translation of the Branch Trial Balance should be transferred to Profit & Loss a/c of Branch.

#### (B) Non-Integral Foreign Branch:

1. **Balance Sheet items** i.e., Assets and Liabilities both Monetary and Non-monetary apply Closing exchange rate.
2. **Items of Income and Expenses** - At the actual exchange rates on the date of transactions. However, AS 11 allows average rate subject to materiality.
3. Any Exchange rate difference should be accumulated in a "Foreign Currency Translation Reserve" (FCTR).
4. FCTR shall be accumulated under Reserves & Surplus as a separate line item.
5. FCTR shall be reclassified to Profit and Loss account on Conversion from Non-Integral to Integral FO.

6. FCTR shall be reclassified to Profit and Loss account on sale/dispose of Non-Integral FO. However, if there is no disposal or sale of FO but only carrying amount is written off then no reclassification is allowed.
7. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss.

### How to Identify Non-Integral Foreign Operation?

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

- I. 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.
- II. Transactions with the reporting enterprise **are not a high proportion** of the foreign operation's activities.
- III. The activities of the foreign operation are **financed mainly from its own operations** or local borrowings rather than from the reporting enterprise.
- IV. 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.
- V. The foreign operation's sales are **mainly in currencies other than the reporting currency**.

## 3. FORWARD EXCHANGE CONTRACTS (FEC)

### Meaning:

- A FEC is an agreement between two parties where by one party **agrees to buy or sell to other party an asset at future date for an agreed price**.
- These contracts are over the counter in an unregulated market.

### Accounting Treatment:

FEC have been classified into two types for the purpose of accounting treatment:

- (1) Forward exchange contracts entered for managing risk (Hedging)
- (2) Forward exchange contracts entered for trading or speculation.

### Forward Exchange Contracts entered For Managing Risk (Hedging):

- Any forward premium/discount should be **amortized/recognized over the tenor** of contract in the profit and loss a/c.
- If the forward contract is cancelled or renewed, the profit or loss arising on cancellation or renewal is recognized in the profit & loss statement for the period.

### Forward Exchange Contracts entered for Trading or Speculation:

- Here forward premium/discount should be ignored.
- At each balance sheet date the value of contract is marked to market, any gain or loss on the contract is recognized immediately.
- Upon sell of forward contract, any profit or loss to be recognized immediately in the statement of profit & loss.

#### Example 6: (Foreign Exchange Contracts Hedge)

Shubham Purchased an asset @35,000 on Credit for 3 months. Date of transaction is 1/3/23 (Payable on 1/6/23)

Exchange Rate on 1/3/23 is \$1 = ₹ 80/-

Shubham is worried that \$ may rise in future & hence Shubham entered into Hedge Contract with HDFC to buy after 3 months. Forward Rate is \$1 = ₹ 82.35/-

Show Accounting in the books of Shubham.

#### Solution:

- 1) Shubham has purchased an Asset in \$35,000. Therefore, this is a "Foreign Currency Transaction". Foreign Currency Transaction should be recorded initially @SPOT Rate i.e., 80/-  
1/3/23

Asset A/c	Dr.	28,00,000	
To Foreign Creditors A/c (\$35,000 × 80)			28,00,000

- 2) On the same day i.e., 1/3/23, Shubham entered into Foreign Exchange (Hedge) Contract to buy dollar @82.35 after 3 months.

It means Shubham has fixed its loss at ₹ 2.35 × \$35,000 = 82,250

As per AS 11, this loss to Shubham is called as "Forward Premium" & it is to be amortised over the life of contract to P&L A/c

$82,250/3 = 27,417/-$

- 3) On 31<sup>st</sup> March 23, Shubham shall recognise 27,417/- loss as under: -

Forward Premium A/c	Dr.	27,417	
To Foreign Creditor A/c			27,417
Profit & Loss A/c	Dr.	27,417	
To Forward Premium A/c			27,417

- 4) On 30<sup>th</sup> April & 31<sup>st</sup> May: Shubham shall pass following entries

30/4/23

Forward Premium A/c	Dr.	27,417	
To Foreign Creditor A/c			27,417
Profit & Loss A/c	Dr.	27,417	
To Forward Premium A/c			27,417

31/5/23

Forward Premium A/c	Dr.	27,416	
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1/6/23	To Foreign Creditor A/c		27,416
	Profit & Loss A/c	Dr.	27,416
	To Forward Premium A/c		27,416
	Foreign Creditor A/c	Dr.	28,82,250
	To Bank A/c		28,82,250

**Example 7: (Speculation)**

Shubham entered into a contract with broker to buy (Long) \$10,000. Contract is made @ \$1 = 80/-.

Actual SPOT Rate today is \$79.75/-

Contract date is 1<sup>st</sup> Feb; Contract is for 3 months

Show the Accounting as per AS 11.

Suppose on 31/3, same contract for 1 month can be made at \$1 = 80.40/-

Actual rate on Contract expiry \$1 = ₹ 81.25/-

**Solution:**

1) Shubham is doing speculation in dollars. Shubham feels that dollar may go up Shubham doesn't want to buy dollar physically.

**2) Accounting Entries:**

(a) On Contract Date: No Entry

(b) On Balance Sheet Date:

Foreign Exchange Contract Receivable A/c		4,000	
Dr.			4,000
To Foreign Exchange Gain (P&L) A/c			
Foreign Exchange Gain A/c	Dr.	4,000	
To P&L A/c			4,000

(c) On Expiry Date / Settlement Date

Foreign Exchange Contract Receivable A/c	Dr.	8,500	
To Foreign Exchange Gain (P&L) A/c			8,500
Cash/Bank A/c	Dr.	12,500	
To Foreign Exchange Contract Receivable A/c			12,500

## 4. (MCQ's from ICAI Study Material)

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

ANSWERS	1	2	3	4	5
	c	b	c	a	c



Student Notes:-