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MFRS Hot Topics

Cash flow statements – common pitfalls and application issues

Part IV - Foreign currency exchange differences

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This is a series of issues that provide guidance on the practical application issues of MFRS 107 Statement of Cash Flows.

Introduction

The Part IV of this series of Hot Topics will highlight the accounting treatment of the impact of foreign currency exchange differences to the cash flow statements.

Part I	Definition of cash and cash equivalents (August 2015 issue)
Part II	Classification of cash flow by activity (September 2015 issue)
Part III	Presentation issues (October 2015 issue)
Part IV	**Foreign currency exchange differences**
Part V	Cash flows relating to business combinations and disposals

When the reporting entity holds foreign currency cash and cash equivalents, these are monetary items that will be retranslated at the reporting date in accordance with MFRS 121. Any exchange differences arising on this retranslation will have increased or decreased these cash and cash equivalent balances. As these exchange differences do not give rise to any cash flows, they should not be reported as any part of the cash flow activities presented in the statement of cash flows. (Their net impact should be disclosed as a reconciling item between opening and closing balances of cash and cash equivalents at the foot of the statement of cash flows, as noted earlier.)

The non-cash impact of the exchange differences needs to be eliminated from the operating, financing and investing cash flows. The method of doing this within the statement of cash flows depends on a number of factors, including whether:

- the exchange difference has been recognised in profit and loss or in other comprehensive income (OCI)
- the related transaction is settled or unsettled
- the related transaction relates to operating, investing or financing activities
- the entity applies the direct or indirect method.

Individual entities

Exchange differences that have been recognised in profit or loss on settled transactions classified as operating activities do not cause any difficulties in the statement of cash flows as they will automatically have been reflected either through the direct cash flows or in the reconciliation from profit to operating cash flows using the indirect method. However, where a settled transaction does not relate to operating activities and the exchange gain or loss is included in profit or loss, it should be removed in the reconciliation required under the indirect method as it will in effect be included as part of the cash flows arising from the settlement disclosed under financing or investing activities.

Example – Foreign currency cash flows

Entity A (whose functional currency is CU) had a balance of cash and cash equivalents of CU10,000, but no trade receivables or trade payables on 1 Jan 20X2. During 20X2, the entity entered into the following foreign currency transactions:

- Entity A purchased goods for resale from Europe for €200,000 when the exchange rate was CU1=€1.5. This balance is still unpaid at 31 Dec 20X2 when the exchange rate is CU1=€1.6. An exchange gain on retranslation of the trade payable of CU8,333 is recorded in profit or loss [€200,000@1.5 = CU133,333; €200,000@1.6 = CU125,000]
- Entity A sold the goods to an American client for $280,000 when the exchange rate was CU1=$2. This amount was settled when the exchange rate was CU1=$1.96. A further exchange gain of CU2,857 regarding the trade receivable is recorded in profit or loss [$280,000@2 = CU140,000; $280,000@1.96 = CU142,857]
- Entity A also borrowed €100,000 under a long-term loan agreement when the exchange rate was CU1=€1.54 and immediately converted it to CU64,935. The loan was retranslated at 31 Dec 20X2 @1.6 = CU62,500, with a further exchange gain of CU2,435 recorded in profit or loss.
- Entity A therefore records a cumulative exchange gain of CU13,625 (8,333 + 2,857 + 2,435) in arriving at its profit for the year.

In addition, Entity A records a gross profit of CU6,667 (CU140,000 – CU133,333) on the sale of the goods.

Analysis

Entity A includes the following amounts in its statement of cash flows using the indirect method of reporting operating activities.

	CU
Profit (13,625 + 6,667)	20,292
Adjustment for:	
Foreign exchange gain on financing item	(2,435)
Increase in trade payables	125,000
Net cash inflow from operating activities	**142,857**
Cash inflow from financing activity	64,935
Net increase in cash and cash equivalents	**207,792**
Cash and cash equivalents at beginning of period	10,000
Cash and cash equivalents at end of period	**217,792**

Foreign operations

In a group situation, a foreign operation may be included in the consolidated financial statements. MFRS 121 requires that the foreign operation's assets and liabilities be retranslated at the closing rate of exchange and income and expenditure items are translated at their actual exchange rate (or an average rate if appropriate). In this case, all exchange differences are recorded in other comprehensive income (OCI), until disposal of the foreign operation when they are reclassified into profit or loss. MFRS 107 requires the foreign operation's cash flows to be translated at the actual exchange rate or an average rate, if appropriate (MFRS 107.26-27).

Care is needed when applying the indirect method in the consolidated statement of cash flows that includes a foreign operation. If translated financial statements of the foreign operation are used, exchange differences will be included in the movements between opening and closing balances of assets and liabilities.

For example, an increase in inventories held by a foreign subsidiary from $240 to $270 during the year will be reported as an unchanged amount of CU150 if the opening rate of CU1=$1.60 becomes CU1=$1.80 by the reporting date. It is therefore advisable to take the functional currency statement of cash flows of the foreign subsidiary as the starting point. The $30 increase in inventories can then be translated at the average exchange rate (assuming this is an appropriate approximation) to achieve the required cash flow amount in the consolidated statement of cash flows. Otherwise, an adjustment is needed to not only account for the exchange difference related to the opening balance but also to reflect the difference between the closing rate used for the closing balance and the average rate used for the recognition of inventory used in profit or loss.

Example – Cash flows of foreign operations (extract)

Entity A (whose functional currency is CU) has a foreign subsidiary entity B, based in the USA. Entity B has an opening balance of inventory of $240 and a closing balance of $270. At the start of the year, the exchange rate is CU1 = $1.60, the closing rate is CU1 = $1.80 and the average rate for the year is CU1 = $1.65.

Analysis

MFRS 107.26 requires that the cash flows of the foreign subsidiary are translated at the actual exchange rate at the time of the transaction, or at an average exchange rate if that is a suitable approximation (MFRS 107.27). The simplest way of presenting the change in inventory of the foreign subsidiary is to identify the change in the subsidiary's functional currency and translate that at the average rate, ie $30 (270-240) @1.65 = CU18.18. This amount is included in the changes in working capital presented in the reconciliation of net cash flows from operating activities using the indirect method.

This can be reconciled as follows:

		CU
Inventories at end of year	($270 @ 1.8)	150
Inventories at beginning of year	($240 @ 1.6)	150
Change in inventory	$30	-
Exchange difference:		
Retranslation of opening balance at closing rate	($240 @1.8 - $240 @ 1.6)	16.67
Retranslation of movement included in profit or loss	($30 @ 1.8 - $30 @ 1.65)	1.51
Increase in inventories reported in the statement of cash flows		**18.18**

Next: Part V Cash flows relating to business combinations and disposals...

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