FOREIGN EXCHANGE RATES IN CONSOLIDATED FINANCIAL STATEMENTS UNDER IFRS

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Abstract: *Companies which carry out foreign operations can perform transactions in foreign currency. In addition, companies can provide financial statements data in a foreign currency. IAS 21 - The Effects of Changes in Foreign Exchange Rates establishes a procedure for performing transactions in foreign currencies and foreign operations for financial reporting, as well as translation of financial statements into the presentation currency. The task of the standard is to disclose information about the exchange rate usage and to reflecting the impact of changes in exchange rates in its financial statements. For reporting under IFRS such currency should be selected, which is actively used and has significant influence on it. This paper summarizes just some aspects of the influence of the exchange rates change effects on the consolidated financial statements according to IFRS.*

Keywords: *IFRS, Foreign Exchange Rates, Consolidated financial statements, Functional currency, Reporting currency.*

JEL classification: *M41.*

Introduction

International Financial Reporting Standards reflect the traditions and conditions of the developed market economies. Development of international standards contributes to the consistency of the whole world of financial information through the harmonization of accounting standards. Fundamental principle of the harmonization of accounting and financial reporting in the world is that the financial system from different countries has to be in accordance with the principles of International Financial Reporting Standards.

Transparency in the fields of national economy is very important because the market value of equity consists of two key factors: the future earnings and future risks. Lenders and investors are willing to get less profit, but they want to be sure that correct and accurate information will reduce their risks.

History of accounting currency transactions according with IFRS is rooted from December 1977, when the E11 was released as a draft of the future standard, "Accounting for Foreign Operations and Conversion of Financial Statements in Foreign Currency." This draft was not to become a full standard. It was processed and released on a new draft E23, "Accounting for the Effects of Changes in Foreign Exchange Rates" in March 1982. After five years of debate in July 1983, the revised draft has gained its final version and was published as an IAS 21 effective from 01.01.1985. In May 1992, a new draft standard E44 "The Effects of Changes in Foreign Exchange Rates", which completely replaced IAS 21 in December 1993 and became obligatory for execution on 01.01.1995. In 2003, the standard was revised and re-integrated from the 01.01.2005 having absorbed the additional changes. There are such main changes: the standard has brought a new term - the functional currency, the combined concepts of foreign entity and a foreign subsidiary in foreign business entity, foreign exchange derivatives were taken outside the scope of IAS 21 and were included in IAS 39 "Financial Instruments: Recognition and Measurement." Subsequently, through adjustments and other changes of IAS 21 has been edited. In 2005, the requirements have changed accounting of net investments in foreign household's unit (April 1989). In 2007, IAS 1 has changed the terminology used in the most of IFRS (effective from 01.01.2009). In 2008, IAS 27, IFRS 3 changed description assess investments in subsidiaries controlled by the parent company, which resulted in changes to IAS 21 (effective from 01.07.2009). During 2009-2011 were also minor amendments to the standard due to change IAS 1 and the new standards IFRS 9, 10, 11, 13 (effective from 2010-2015). We can state that every ten years the standard undergoes a radical processing. This is caused by the current situation of the world economy and by the current requirements for financial reporting system.

History of Consolidated Financial Statements according with IFRS is rooted from September 1987, when the E30 was released as a draft of the future standard, "Consolidated Financial Statements and Accounting for Investments in Subsidiaries". This draft become a full standard IAS 27 in April 1989 and become effective from January 1990. In December 1998 IAS 27 was amended by IAS 39 "Financial Instruments: Recognition and Measurement", effective 1 January 2001. In 2003, 2005, 2008 were also minor amendments which become effective from 2005, 2008, 2009. In 2003 standard change the title to "Consolidated and Separate Financial Statements". In May 2010 IAS 27 amended for transitional requirements for consequential amendments and become effective from July 2010. May 2011 reissued as IAS 27 "Separate Financial Statements" as amended in 2011. Consolidation requirements previously forming part of IAS 27 have been revised and are now contained in IFRS 10 "Consolidated Financial Statements", effective for annual periods beginning on or after 1 January 2013.

The order of transactions in foreign currencies and foreign operations for financial reporting of an organization, as well as translation of financial statements into the presentation currency is set to IAS 21 "The Effects of Changes in Foreign Exchange Rates". This standard is as follows:

- Taking into account transactions and balances in foreign currency;
- The reflection of results and financial performance of foreign operations are to be included into the financial statements of the organization methods of consolidation, proportionate consolidation or the equity method;
- The reflection of the results and financial performance of organizations in reporting currency.

However, this rule has some exceptions:

- In respect of derivative (financial instruments), which are proceeding according to under the IAS 39 "Financial Instruments: Recognition and Measurement". In particular, IAS 21 does not apply to hedge accounting of articles in foreign currencies, including the hedging of net investments in foreign operations;
- In respect of the statement of cash flows which arise from transactions in foreign currency or converting cash flows from foreign operations.

In this paper we will discuss the most typical mistakes made by Czech enterprises in consolidated financial statements. It often occurs pertains to different or foreign currencies between mother and subsidiary entities. To overcome these problems let's try to find the rationale between the functional currency and exchange rate. As Mr. Revsine Lawrence wrote in his famous paper in 1984, statement manipulation via the functional currency choice does not appear to be a major threat since firms have a built-in motive to make the “correct” choice. For example, firms would be ill-advised to select the dollar as the functional currency in order to gain some near-term income enhancement [7]. Unfortunately in our days it has become a major threat since exchange rates on the world financial markets are not stable during the last 10 years. Companies use this situation to gain income enhancement. And often “close eyes” for philosophy of IAS 21 and just use formal requirements. Unfortunately the paper is not to be longer than 12 pages, so we can discuss just some of the typical problems and use illustrative cases for every example.

Scientific methods which the author use in preparing the paper. Thus, to achieve the goal, the scientific methods of analysis, synthesis, abstraction and deduction will mainly be used. The paper is based not only on theoretical grounds, but primarily from empirical research that has been linked to the theoretical possibilities of business processes. The paper lies in the analysis of the state of facts, the way they are currently recognized and how exchange rate differences are currently reported in financial statements. The analysis conducted on the basis of 35 consolidated financial companies’ statements. These data were summarized and verified. Using empirical induction and logical deduction author will be made an attempt which method is feasible and can be applied in the current situation.

1 Different reporting dates of the financial statements of parent and subsidiary companies

1.1 Statement of a problem

In multi-national companies (owning subsidiaries, controlled entities in different countries) there often happens a situation when the dates of the financial statements of parent and subsidiary are different. This situation can arise when the national legislation establishes the mandatory date of the financial statements of enterprises, or a company itself establishes the date of the financial statements basing on economic or some other feasibility of each entity. If the companies are located in different countries, obviously this leads to the preparation of financial statements in different functional currencies. Then, the financial statements must be translated into the reporting currency of the parent company for consolidating financial statements.

1.2 Problem solving

In order to consolidate the financial statements, companies must abide the following rules. As required by IAS-27 "Consolidated and Separate Financial Statements" subsidiaries should be preparing the financial statements of the parent using of the same date. If a subsidiary has a different reporting period, the subsidiary prepares an additional financial statement for the same date as the parent. In this case subsidiaries use the same date for exchange rate as it is used by the parent's financial statements to translate the subsidiaries statement.

According to IAS-27 a subsidiary is also allowed to use a different reporting date than the date of the parent's financial statements date. The difference between the end of the reporting period of the subsidiary and that of the parent should be no more than three months [IAS 27 para 23]. It means a different reporting date which is not more than three months before or after the reporting period of the parent's financial statements date. In this case the exchange rate ruling at the foreign operation financial statements date will be used to translate the foreign subsidiaries statement. If a subsidiary uses a different reporting date, it should show all material transactions and events occurred between the dates of financial statements of the parent and subsidiary in its financial statements. Thus we have the following options:

- A subsidiary should prepare the financial statements of the parent's using the same date. In this case a subsidiary uses the exchange rate at the parent's financial statements date to translate the subsidiaries statement.
- A subsidiary should prepare the financial statements of the parent's which shall be no more than three months and should view all material transactions and events. In this case the subsidiary uses the exchange rate the same as at the subsidiary financial statements date to translate the subsidiaries statement.
- A significant event that can only be a reason for translation (retranslation) of financial statements in connection with a major change of the exchange rate. The exchange rate ruling at the foreign operation financial statements date will be use to translate the foreign subsidiaries statement.
- A subsidiary doesn't do anything in the absence of any significant transactions or events.

Let's try to translate a subsidiary financial statement in to foreign currency with a different reporting date of the parent's consolidated financial statements.

Conditions: A parent company prepares its consolidated financial statements for March 31, 2XXX+1. Subsidiary company, according to the season production period prepares its financial statements for December 31, 2XXX. The exchange rate between EURO and Czech crown was: 1Euro: 25CZK on December 31, 2XXX, 1Euro: 25.25CZK on March 31, 2XXX+1.

In the first place the following to the season production in agriculture between January -March subsidiary company did not have any activity in its main field. In the second place: if some significant event happens it would be time to decide which exchange rate we need to use in that case. The subsidiary net assets were 25 million CZK in the financial statements. According to the exchange rate on December 31, 2XXX, net assets in EURO value are 1 million EURO. According to the exchange rate on March 31, 2XXX+1, net assets in EURO value are 990 099.00 EURO. The difference is **9 901.00 EURO** or **1 percent** of net assets. Is it significant or not? The company chief staff has to justify the economic expediency of the solution and to take the decision of making or not making the retranslation of financial statements.

1.3 Discussion

During the analysis of the consolidated financial statements there happens a typical situation. When the dates of the financial statements of the parent and subsidiary companies are different, the foreign subsidiaries prepare the financial statements of the parent used for the same date. And they do it quite often, when these changes are not economically feasible. The analysis conducted on the basis of 35 consolidated financial statements indicates that only 7 subsidiaries out of the 35 consolidated financial statements had different reporting dates. In all these consolidated financial statements, all statements of subsidiaries were prepared on the date of the financial statements of parent companies. After making analysis of the consolidated financial statements, the usefulness of the new statements of subsidiaries due to significant changes in the structure of assets for 3 entities has been recognized. For two consolidated financial statements, statements of subsidiaries should only translate according to the major change of exchange rate. In the last two consolidated financial the statements of subsidiaries shouldn't change. It was not economically feasible to draft new subsidiaries statements for the two remaining consolidated reports, since the activities of the subsidiaries were seasonal in nature and in the period of difference between reporting dates the main economic activities of subsidiaries were missing and any events affecting the operations of subsidiaries did not occur.

2 Profit and loss from intra-group transaction in assets

2.1 Statement of a problem

A foreign currency in financial statement can be presented as a transaction and / or an investment. Transactions in a foreign currency include: buying, selling, cash, passive investing. Investments in a foreign currency include: the equity method, and the consolidation method. IAS 21 does not use term "Investments", it uses the term "Translations". In cases of intra-profits/losses at the sale/purchase of assets between companies within a group and if this asset is not purchased outside the group (this asset is on the balance sheet on the date of the consolidated financial statements) IFRS requires the exclusion of it's the profit/loss of consolidated financial statements, [IAS 27 para 21]. This requirement is to prevent speculative image of fictitious profits/losses. When data transactions a being displayed a problem arises on what exchange rate this profit/loss should be eliminated. Unfortunately IAS 21 does not contain any requirements on the subject.

2.2 Problem solving

Problem solving is based on the theoretical possibilities that are known to the author.

We can use the following options:

- The exchange rate valid on the date of the transaction (the emergence of profit / loss),
- the average exchange rate for the reporting period,
- the exchange rate valid on the date of the consolidated financial statements.

The choice of a particular option should be implemented on the base of economic feasibility. Not every option may be used for example, in a hyperinflationary economy. These examples show us the impact of exchange rate changes on the company's share capital. Let's try to eliminate profit in consolidation financial statement using different methods. We'll see how the exchange rate affects the consolidated financial statements.

Conditions: A parent company buys / sells assets (inventory) from / to the Czech subsidiary company for 2.55 million CZK or 100 000 EUR at November 25, 2XXX and these assets are stay on the parent / subsidiary balance sheet at December 31, 2XXX. Assets cost **70 000 EUR** or **1.785 million CZK**. The exchange rate between EURO and Czech crown was as following: 1Euro: 25.5CZK at November 25, 2XXX, 1Euro: 25CZK at December 31, 2XXX, average year rate 1Euro: 26CZK.

Option One: The exchange rate valid on the date of the transaction (the emergence of profit). The parent company buys assets from the Czech subsidiary company for 2.55 million CZK. At the transaction day value of the assets for parent company in balance sheet will be 100 000 EUR (2 550 000/25.5). According to IAS 27 the profit of this operation is to be eliminated from a consolidation financial statement. The assets cost 1.785 million CZK. According to the actual rate exchange ruling at the transaction date 30 000 EUR (2 550 000/25.5 -1 785 000/25.5) of profit will be eliminated. The value of the assets will be **70 000 EUR** (100 000 - 30 000) in the consolidated financial statement. This method does not reflect the impact of exchange rate fluctuations in the financial statements. In this example it is a positive factor.

Option Two: the weighted average exchange rate for the reporting period. The parent company buys assets from the Czech subsidiary company for 2.55 million CZK. At the transaction day value of the assets for parent company in the balance sheet will be 100 000 EUR (2 550 000/25.5). According to IAS 27, profit of this operation is to be eliminated on a consolidation financial statement. The assets cost is 1.785 million CZK. According to the average exchange rate prevailing on the fiscal year 29 423 EUR ((2 550 000 -1 785 000) / 26) of profit will be eliminated. The value of the assets will be **70 577 EUR** (100 000 - 29 423) in the consolidated financial statement. The exchange rate presents the difference of **577 EUR** arising on the consolidation financial statement using average rate method.

Option Three: the exchange rate valid on the date of the consolidated financial statements. A parent company sells assets to the Czech subsidiary company for 100 000 EUR. On the transaction day the value of the assets for subsidiary company in the balance sheet will be 2.55 million CZK (100 000 * 25.5). For the consolidated financial statement the subsidiary company must translate its own financial statement to the presentation currency EURO. It will use current rate method. The value of the assets will be **72 000 EUR** (2 550 000 / 25 minus profit 30 000). The exchange rate presents the difference of **2 000 EUR** arising on the translation to the presentation currency using the current rate method.

2.3 Discussion

During the analysis of the consolidated financial statements we have to deal with the fact that companies tend to use the weighted average exchange rate. The analysis conducted on the basis of 35 consolidated financial statements indicates that out of 35 consolidated financial statements 32 had unrealized intra-group profit and / or loss. Out of the 32 consolidated financial statements the three reports were used by the weighted average exchange rate for the reporting period, 28 the exchange rate valid at the date of the consolidated financial statements, 1 the exchange rate effect on the date of the transaction. In the analysis of the consolidated financial statements, the author believes it is appropriate to use the exchange rate valid on the date of the transaction (the emergence of profit), although it is not the easiest from the methodological point of view. But at the same time, exchange rate differences do not affect the company's share capital. This method is appropriate in the case when you do not need further translation of financial statements in the presentation currency for the consolidated financial statement. The current rate method in the third option has a significant impact of exchange rate changes on the company's share capital. This method is due to the requirement of IAS 21, which in the edition of 2005 annulled the remeasurement method, leaving no choice to the enterprise.

3 Dividends in consolidated financial statements

3.1 Statement of a problem

Entities which generate a profit usually are part of the profits paid to their shareholders. Their shareholders that had having made a decision regarding the payment of a dividend, a subsidiary must to pay dividends to their parent company. If a subsidiary pays dividends in a currency rather than the functional currency of a foreign subsidiary (currency such as used by the parent company) and at the accrual and payment dates are different, as well as exchange rate changes, then the exchange rate differences are arising. At the parent company, the situation is opposite. If the subsidiaries pay dividends in the functional currency, while the parent company uses a different currency, and thus the date of calculation and payment are different, as well as exchange rate changes, the exchange rate differences are in the parent company. The problem of accounting data exchange differences on consolidation of financial statements is very relevant today.

3.2 Problem solving

Considering what situations may arise, provided that the functional currency of the parent and subsidiary are different, the date of calculation and payment are also different, the exchange rate is unstable and changing.

Problem solving is based on the theoretical possibilities that are known to the author.

We can use the following options:

- A subsidiary pays dividends in the functional currency, while the parent company uses a different currency,
- a subsidiary pays dividends in the currency used by the parent company (other currency, rather than the functional currency of a foreign subsidiary),
- a subsidiary pays dividends in a currency, rather than the functional currency of the subsidiary and the parent company (in practice the author hasn't met such as example).

Let's try to eliminate gain or loss of exchange rate in consolidation financial statement using different situations. We'll see how the exchange rate affects the consolidated financial statement.

Conditions: A Czech subsidiary company (Czech crown is a functional currency) decides to pay dividends to the parent company (EURO is a functional currency) at November 25, 2XXX. The dividend was paid on February 1, 2XXX +1. The exchange rate between EURO and Czech crown was such: 1Euro: 25.5CZK at November 25, 2XXX, 1Euro: 25CZK at December 31, 2XXX, average year rate 1Euro: 26CZK.

Option One: the Czech subsidiary company declared a dividend in Czech crown 2.55 million CZK. Let's see how this amount will be displayed in the financial statements of subsidiary company, the parent company and the consolidated financial statement.

The Subsidiary Statement of Financial Position current rate method is used to the presentation currency EUR

Dividend payable – 102 000 EUR (2 550 000 / 25)

The Parent Statement of Financial Position current rate method is used for the closing date

Dividend receivable – 102 000 EUR (2 550 000 / 25)

The Parent Statement of Comprehensive Income

Dividend earning – 100 000 EUR (2 550 000/25.5)

Currency earning – 2 000 EUR (2 550 000/25-2 550 000/25.5)

Total earning – 102 000 EUR

The Consolidated Statement of Comprehensive Income

Dividend earning – 100 000EUR

Currency earning – 2 000 EUR

Option Two: a Czech subsidiary company declared a dividend in EURO 100 000. How will this amount be displayed in the financial statements of subsidiary company, the parent company and the consolidated financial statement?

The Subsidiary Statement of Financial Position current rate method is used to the presentation currency EUR

Dividend payable – 100 000 EUR (2 500 000/25)

The Subsidiary Statement of Comprehensive Income

Dividend – 100 000 EUR (2 550 000/25.5)

Currency earning – 2000 EUR ((100 000*25.5-100 000*25) /25)

The Parent Statement of Financial Position current rate method is used for the closing date

Dividend receivable – 100000 EUR

The Parent Statement of Comprehensive Income

Dividend earning – EUR 100 000

The Consolidated Statement of Comprehensive Income

Dividend earning – EUR 100 000

Currency earning – 2000 EUR

3.3 Discussion

The analysis of the consolidated financial statements shows that companies are constantly creating a situation where the date of accrual and payments are not the same and usually carried out in different periods. It is a usual practice nowadays because, as between the date of decision of the shareholders' regarding the payment of a dividend and the actual payment take several months. The author is aware of the case where the delay in payment of the dividend reached 2 years. The payment was blocked by one of the shareholders to influence on other shareholders. The analysis conducted on the basis of 35 consolidated financial statements indicates that all parent companies received dividends. Out of the 35 consolidated financial statements of parent companies 33 received dividends in functional currency and two parent companies received dividends in the functional currency of the subsidiary. Thus, the parent company's shifted currency risks in the payment of dividends on subsidiaries. As the author believes, these are common mistakes.

In case of dividend payments in the functional currency of the parent company from 33 subsidiary's income statements in 5 of them was found incorrect reflection of the dividends on the last date of reporting. So, as no dividends were paid, subsidiaries this amount of accrued dividends reflected the exchange rate on the date of the financial statement. Arguing that fact that the accrued dividends subject to foreign exchange risks and the equivalent in local currency debt of the subsidiary is not a constant. This statement is erroneous. Reflecting the amount of the dividend is not a monetary obligation, it is a transaction which reduces capital subsidiary. Therefore, when displayed in the income statements using the historical exchange rate at the date of the transaction. Monetary obligation is payable dividend to the parent company which subjects to recalculation of the balance sheet date.

In the consolidated financial statements of enterprises the most controversial, and for the author's opinion erroneous, is to display an exchange difference from the debt dividend. Of the 35 consolidated incomes statement at 12 companies this income statements exchange rate differences with relates to dividend reclassified to equity (because dividends belong to equity) and removed from income statement. The author believes that this exchange rate difference is the income / loss of monetary nature. So, it’s a direct impact on cash flows. Therefore, this exchange difference should be included in the gain or loss of the Statement of Comprehensive Income. The author does not find the information that this situation is governed by IFRS standards. The author think that in this example, we must be guided by economic expediency and reflect the real economic substance of transactions.

Conclusion

Nowadays International Financial Reporting Standards are an effective tool to improve the transparency and clarity of information that reveals the activities of operators, creates a reliable basis for recognition of revenues and expenses, assets and liabilities, which allows to publish and objectively reflect the current financial risks, the entity and to compare the performance to ensure adequate assessment of their potential and make appropriate management decisions. In addition, IFRS has an impact on the quality management capabilities to manage the organization and provide significant advantages over its competitors. For individuals who are reporting under IFRS it is even better opportunity to attract other sources of capital and business partners to help to generate economic growth and prosperity. On the other hand, entities using IFRS have access to the information about the financial situation of potential partners, which serves as another tool of their choice.

The major goal of the paper was to describe the real process and the effects of changes in foreign exchange rates, establishes a procedure for perform transactions in foreign currencies and foreign operations for consolidated financial statements in Czech entities which act under IFRS and are trying to find economic expediency option to use IFRS demands. The issue of reporting of consolidated financial statements pointed out where problems arise with a variety of functional currencies of the consolidated entities, different reporting dates, profit and loss from intra -group transaction in assets and dividends. From the research of the 35 enterprises it was obvious that the current world trend, focusing on abused while reporting method allowed but unacceptable from an economic point of view, take place in Czech Republic. The author tried to create all possible theoretically reporting capabilities in individual cases described the problems and then evaluate it and comes to the conclusion that the company must evaluate the selected methodology of reporting in each individual case in terms of economic expediency. As shown in each chapter of the article in each methodology used companies use incorrect procedures. As for example in chapter "different reporting dates" 7 statements of subsidiaries were prepared on the date of the financial statements of parent companies and just usefulness of the 3 new statements of subsidiaries due to significant changes has been recognized. In the view and experience of the author, these bugs usually occur of formal approaches to a reporting methodology (that facilitating the reporting of enterprises) or purposeful use of authorized methodologies (that skew the results in favor of the company). Question arises, what is to do to avoid this possibility. This is the topic for the next discussion/paper. The research results can be used to verify how Czech companies have possibility of adapting their statements under IFRS to reflect real situation of the company. At the same time we may discuss if IASB must to make more restrictive and/or circumstantial demands for IAS 21. It should be noted. The paper was presented only part of the research results because of the size restrictions of a paper.

Sometimes IFRS doesn't give answer for some specific situation. Mr. Revsine came to opinion in his paper that making the selection clearly understands the theory underlying the choice, an incorrect selection is very likely using a straightforward tally of the indicators in each direction [7]. For this reason and to my opinion the entity management must be ready to prove a methodological point of view that it subtle philosophy of IAS 21 that underlies the functional currency and the exchange rates which the entities used in financial statement. The transition to international standards should certainly be a gradual and deliberate process. The importance of this process lies in the fact that gaps and inconsistencies in national accounting system are solved gradually in accordance to the needs of the market economy without disrupting the system. Moreover, the transition to IFRS requires time to practice, try new techniques and procedures for collecting and processing the information.

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