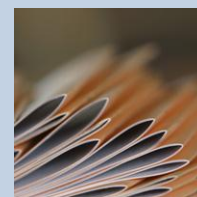


Canadian GAAP - IFRS Comparison Series Issue 6 – Foreign Exchange



Both IFRS and Canadian GAAP are principle based frameworks, and from a conceptual standpoint many of the general principles are the same. However, the application of those general principles in IFRS can be significantly different from Canadian GAAP. Therefore, to understand the magnitude of the differences between the two, it is essential to look beyond the general principles and examine the detailed guidance provided in the standards. This is our sixth issue in a series of publications which will provide detailed information on the key differences between IFRS and Canadian GAAP.

In this issue the focus will be on foreign currency translations, namely:

- The translation of transactions denominated in a foreign currency; and
- The translation of financial statements for foreign operations including those in hyper inflationary economies.

Be advised that this publication is a guide to the differences between Canadian GAAP and IFRS and is not meant to be a comprehensive manual. Please contact a BDO Dunwoody representative for specific details and information.

References

IFRS: IAS 21 – The Effects of Changes in Foreign Exchange Rates.

Canadian GAAP: Section 1651 – Foreign Currency Translation, EIC 130 – Translation Method when the Reporting Currency Differs from the Measurement Currency or there is a Change in the Reporting Currency.

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Introduction

Canadian GAAP and IFRS are similar standards in that they both cover the translation of transactions and financial statements of foreign operations; however, the way in which each approach these translations can differ significantly.

Determination of Functional Currency

To enable translation of foreign currency transactions or foreign operations both Canadian GAAP and IFRS require an assessment of the basis or unit of measure, or what is termed the functional currency under IFRS. However, the way in which these assessments are made are very different and may have significant implications for Canadian entities with foreign currency transactions or operations.

Canadian GAAP	IFRS
<p>When a reporting entity prepares financial statements it is required to assess the basis or unit of measure for any foreign operations.</p> <p>However, the reporting entity is not explicitly required to assess the basis or unit of measure for its own financial results and position.</p>	<p>One of the fundamental requirements of IFRS is that when a reporting entity prepares financial statements each individual entity included in those statements must determine its own functional currency and measure its own results and financial position in that currency.</p> <p>This explicit requirement applies whether the individual entity is a stand alone entity, an entity with foreign operations (e.g. a parent company) or is actually the foreign operation (e.g. a subsidiary or branch).</p>
<p>Canadian GAAP refers to the unit or basis of measurement for the translation of assets, liabilities, revenues and expenses.</p>	<p>IFRS refers to functional currency, which is the currency of the primary economic environment in which the entity operates.</p> <p>The functional currency of an entity should reflect the underlying transactions, events and condition that are relevant to the entity.</p>
<p>The method of translation of the foreign operation is dependent on the classification of the foreign operation – an integrated foreign operation or a self-sustaining foreign operation.</p> <p>If the foreign operation is an integrated foreign operation, the functional currency of the foreign operation is the same currency as the parent company. The functional currency is the currency that the transactions are measured in.</p> <p>If the foreign operation is self-sustaining, the functional currency of the foreign operation is not the same as the parent. The functional currency of the foreign operation is the foreign</p>	<p>IFRS does not classify the foreign operation into integrated or self-sustaining foreign operations. The entity must determine its own functional currency and measure its own results and financial position in that currency.</p> <p>The determination of functional currency is based on the primarily economic environment in which the entity operates.</p> <p>The following factors are to be considered:</p> <ul style="list-style-type: none">- The currency that mainly influences sales prices for goods and services (often the currency in which sales prices for its goods and services are denominated and settled);

<p>currency. Therefore, the foreign operation's financial statements need to be converted to the reporting currency, which is the parent company's functional currency.</p> <p>The classification into integrated or self-sustaining foreign operations is based on a professional judgment evaluation of the economic facts and circumstances specific to that foreign operation. For example:</p> <ul style="list-style-type: none"> - Are the reporting entities cash flows insulated from or affected by the day to day activities of the foreign operation? - Are sales prices determined by local market forces or worldwide forces? - Where is the foreign operations sales market – primarily outside or within the reporting entities country? - Are labour, materials and other costs of products and / or services incurred outside or within the reporting entities country? - Are the day-to-day activities of the foreign operation financed by its own operations or borrowings incurred locally, or within the reporting entities country? - Is there a day-to-day interrelationship between the foreign operation and the reporting entity? 	<ul style="list-style-type: none"> - The currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services; and - The currency that mainly influences labour, material and other costs of providing goods or services (often the currency in which these costs are denominated and settled). <p>These factors take precedence. Only if these indicators are mixed or unclear will an entity need to look to the following factors, which may also provide evidence of an entity's functional currency. These factors include:</p> <ul style="list-style-type: none"> - The currency of financing activities (i.e. issuing debt and equity instruments); and - The currency in which receipts from operating activities are usually retained. <p>Furthermore, the following additional factors may also be considered:</p> <ul style="list-style-type: none"> - Are the activities of the foreign operation carried out as an extension of the reporting entity, or with a significant degree of autonomy? - Are transactions between entities a high or a low proportion of the foreign operation's activities? - Are cash flows from the activities of the foreign operation directly affecting the cash flows of the reporting entity? Are they readily available for remittance to the reporting entity? - Are cash flows from the activities of the foreign operation sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity? <p>This may result in a different currency being determined as the functional currency than what is the current basis of measurement under Canadian GAAP.</p>
<p>The method of translation of the foreign operation should not be changed unless there are <u>significant</u> changes in the economic facts and circumstances that indicate a different translation method should be used.</p> <p>When a significant change occurs the change in translation method should be accounted for on a prospective basis.</p> <p>Any exchange gain or loss balance included in</p>	<p>Under IFRS once the functional currency is determined, it can be changed only if there is a change to those underlying transactions, events and conditions.</p> <p>Similar to Canadian GAAP this change should be accounted for on a prospective basis. Any exchange gain or loss balance included in accumulated OCI at the date of the change in functional currency, will continue to be included there.</p>

accumulated OCI continues to be included there. This balance is transferred to net income only on disposal of the foreign operation.	Similar to Canadian GAAP this balance is transferred to profit and loss only on disposal of the foreign operation.
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Translation of Foreign Currency Transactions

Canadian GAAP	IFRS
At the transaction date, each asset, liability, revenue or expense should be translated using the exchange rate in effect at that date.	Like Canadian GAAP each asset, liability, revenue or expense should be translated using the exchange rate in effect at the transaction date, termed the "spot rate." IFRS explicitly states that the transaction date is the date the transaction first qualifies for recognition under IFRS. A weekly or monthly average exchange rate that approximates the actual exchange rate can be used, unless there are significant fluctuations in the exchange rate.
At each balance sheet date: <ul style="list-style-type: none"> - Monetary items denominated in a foreign currency are translated to reflect the exchange rate at the balance sheet date; - Non-monetary items carried at fair value are translated to reflect the exchange rate at the balance sheet date; and - Non-monetary items carried at historical cost are translated using the exchange rate at the date of the transaction. 	At each balance sheet date: <ul style="list-style-type: none"> - Foreign currency monetary items are translated to reflect the exchange rate at the balance sheet date; - Non-monetary items measured at fair value, net realizable value or recoverable amount in a foreign currency are translated using the exchange rates at the date the fair value was determined, which in many, but not all, cases will be the rate at the balance sheet date; and. - Non-monetary items measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.
Any exchange gain or loss arising on translation or settlement of a foreign currency denominated monetary item is recognized in net income for the current period, unless the monetary item is an available for sale financial instrument. The unrealized gain or loss including the amount related to changes in exchange rates is recognized in other comprehensive income, other than in the case of impairment.	Exchange differences arising on the settlement or translation of monetary items are recognized in profit and loss in the period they arise unless the monetary item forms part of the reporting entity's net investment in a foreign operation. In this case the group consolidated accounts record the exchange difference in Other Comprehensive Income (OCI) and Accumulated OCI. The exchange gain or loss is only transferred to the Profit and Loss on disposal, in part or in full, of the net investment. There is no exception for available for sale monetary items. Under IFRS the foreign exchange portion of

	<p>the gain or loss will have to be segregated and reported in net income, while the remainder of the gain or loss is recognized in OCI.</p>
<p>Any exchange gain or loss arising on translation or settlement of a foreign currency denominated non-monetary item carried at fair value is recognized in net income for the current period, unless the monetary item is an available for sale financial instrument. The unrealized gain or loss including the amount related to changes in exchange rates is recognized in other comprehensive income, except in the case of impairment.</p>	<p>The recognition of exchange gains or losses arising non-monetary items is linked to the recognition of gains or losses of the non-monetary item itself. For example, an accounting policy choice exists in relation to property, plant and equipment which also determine where any gain or loss is recognized. If the property, plant and equipment are valued at cost less accumulated depreciation, then any gains or losses are recorded in Profit and Loss. However, if the property, plant and equipment are revalued to fair value, then any gains or losses are recorded in equity, as a revaluation reserve.</p> <p>If the non-monetary item gain or loss is recognized in Profit and Loss, then any foreign exchange gain or loss on that non-monetary item is also recorded in Profit and Loss. Therefore, any exchange gain or loss on property, plant and equipment recognized at cost less accumulated depreciation will be recorded in Profit and Loss.</p> <p>If the non-monetary item gain or loss is recognized directly in equity, then any foreign exchange gain or loss on that non-monetary item is also recorded in equity – Accumulated OCI. Therefore, any exchange gain or loss on property, plant and equipment recognized at fair value will be recorded in OCI.</p> <p>In the case of non-monetary available for sale financial instruments, like Canadian GAAP the foreign currency portion of unrealized gains / losses would be recognized in OCI.</p>
	<p>IFRS also contemplates the situation where the books and records of the reporting entity are not prepared in functional currency of that reporting entity. Where this occurs, the reporting entity is required to use the transaction translation methods described above to translate the books and records into the functional currency.</p> <p>This effectively produces the same result as if the items been recorded initially in the functional currency.</p>

Translation of a Foreign Operation

The approach of Canadian GAAP and IFRS in translating the results and financial position of a foreign operation into a presentation currency are different.

Canadian GAAP	IFRS
<p>The translation of a foreign operation requires an entity to apply the temporal or current rate translation method, depending on whether the foreign operation is classified as integrated or self-sustaining, unless the economic environment of the foreign operation is highly inflationary relative to that of the reporting entity. Where this is the case the temporal method of translation is to be used.</p> <p>For integrated foreign operations, or those highly inflationary economies, the temporal method of translation is used. This requires:</p> <ul style="list-style-type: none"> - Monetary items to be translated at the exchange rate in effect at the balance sheet date; - Non-monetary items to be translated at historical exchange rates, unless such items are carried at market, in which case they are translated at the exchange rate in effect at the balance sheet date; - Revenue and expense items are translated at the exchange rate in effect on the dates they occur; and - Depreciation or amortization of assets translated at historical exchange rates is translated at the same exchange rates as the assets to which it relates. <p>Using this method retains the basis of measurement in Canadian dollars (or the parent entity's currency).</p> <p>For self-sustaining foreign operations the current rate method of translation is used. This requires:</p> <ul style="list-style-type: none"> - The income statement and the cash flow statement items for each year (or period) to be translated into the reporting currency using the rates in effect at the date of the transactions; - Assets and liabilities to be translated using the exchange rate at the end of that year or period (closing rate); and 	<p>IFRS does not distinguish between the types of foreign operations. The translation of foreign operation financial statements at each balance sheet date for consolidation purposes requires:</p> <ul style="list-style-type: none"> - Assets and liabilities for each balance sheet presented (i.e. including comparatives) to be translated at the closing rate at the date of that balance sheet; - Income and expenses for each income statement (i.e. including comparatives) to be translated at exchange rates at the dates of the transactions; and - All resulting exchange differences to be recognized as a separate component of equity.

<ul style="list-style-type: none"> - All resulting exchange differences to be recognized as a separate component of accumulated OCI. <p>Using this method, transactions and balances retains the basis of measurement in terms of the foreign currency (the currency of the foreign operations financial statements).</p>	
<p>A proportionate amount of the exchange gains and losses accumulated in the separate component of accumulated OCI is recognized in net income when there has been a reduction in the net investment. This occurs where:</p> <ul style="list-style-type: none"> - The reporting enterprise's interest in the foreign operation is diluted or sold (in part or in full); - The equity of the foreign operation is reduced as a result of capital transactions (for example, dividend distributions, capital restructuring); and - The net investment is reduced. 	<p>On the disposal of an entity's entire interest in a foreign operation the cumulative amount of the exchange differences deferred in the accumulated OCI relating to that foreign operation are recognized in profit or loss when the gain or loss on disposal is recognized.</p> <p>In addition, the loss of the following are accounted for as disposals even if the entity retains an interest in the former subsidiary, associate or jointly controlled entity, the loss of:</p> <ul style="list-style-type: none"> - Control of a subsidiary that includes a foreign operation; - Significant influence over an associate that includes a foreign operation; and - Joint control over a jointly controlled entity that includes a foreign operation. <p>Where the disposal relates to that of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests is derecognized, but is not reclassified to profit or loss. However, where the disposal is only partial (i.e. any reduction in an entity's ownership interest in a foreign operation, except those examples above that are accounted for as a disposal), the entity re-attributes the proportionate share of the cumulative amount of the exchange differences recognized in OCI to the non-controlling interests in that foreign operation.</p> <p>In any other partial disposal of a foreign operation the entity reclassifies to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognized in OCI.</p> <p>The disposal or partial disposal may be by way of sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity. However, a write-down of the carrying amount of a foreign operation does not constitute a partial disposal.</p>

Use of a Presentation Currency other than the Functional Currency

The requirements of Canadian GAAP and IFRS related to using a presentation currency which is not the functional currency are similar; with both allowing a reporting entity to present its financial statements in a currency that is different from its measurement or functional currency.

Canadian GAAP	IFRS
<p>When an entity presents financial statements in a currency other than the functional currency, the financial statements should be translated into the reporting currency using the current rate method.</p> <p>Using the current rate method requires:</p> <ul style="list-style-type: none"> - The income statement and the cash flow statement items for each year (or period) to be translated into the reporting currency using the rates in effect at the date of the transactions; - Assets and liabilities to be translated using the exchange rate at the end of that year or period; and - All resulting exchange differences to be recognized as a separate component of accumulated OCI. <p>Where a change in reporting currency occurs, the financial statements for all years (or periods) presented should also be translated into the reporting currency using the current rate method. This results in the financial statements of prior years, presented for comparison, being translated as if the reporting currency used in the current year had been used for at least all periods shown.</p>	<p>The method of translation of the functional currency results and financial position, including comparatives, of an entity into a different reporting currency is dependent on whether or not the reporting currency is the currency of a hyper inflationary economy.</p> <p>Where the functional currency is not that of a hyper inflationary economy:</p> <ul style="list-style-type: none"> - Assets and liabilities included in the current and / or comparative period balance sheets are translated at the closing rate at the date of that respective balance sheet; - Income and expenses for each income statement (i.e. including comparatives) are translated at exchange rates at the dates of the transactions (or at an average rate to approximate transaction date rates); and - All resulting exchange differences are recognized as a separate component of accumulated OCI. <p>Where the functional currency is that of a hyper inflationary economy all assets, liabilities, equity items, income and expenses, (restated in accordance with IFRS and including comparatives) are translated at the closing rate at the date of the most recent balance sheet, except when translated into a currency of a non- hyper inflationary economy. When this occurs there is no change to the comparative amounts that were presented as current year amounts in the relevant prior year financial statements.</p>

Taxes

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. The accounting for the tax effects can also be different under Canadian GAAP and IFRS. For example Canadian GAAP states that no future (deferred) income tax asset or liability should be recognized for any temporary difference arising from the difference between the historical exchange rate and the current exchange rate translations of the cost of non-monetary assets or liabilities of integrated

foreign operations. IFRS does not have an equivalent exclusion paragraph to this and, as a result, IFRS may result in deferred tax arising in cases where they would not under Canadian GAAP.

First Time Adoption Issues

As discussed IFRS in certain circumstances requires certain exchange gains and losses to be recognized in accumulated OCI. This is similar to how an entity would recognize gains and losses arising from translating self-sustaining foreign operations using the current rate method. These exchange gains and losses are subsequently only transferred to profit and loss on disposal, in part or full, of the related foreign operation.

IFRS 1: *First-time Adoption of International Financial Reporting Standards* provides an exemption to this requirement as it allows a first time adopting entity to elect not to calculate this translation difference retrospectively. Where this election is made the cumulative translation balance for all foreign operations is set to zero, at the date of transition. The gain or loss on subsequent disposal of a foreign operation will therefore only include foreign exchange differences arising subsequent to the date of transition.

This election could be beneficial to Canadian entities that may want to 'tidy' up the cumulative translation balance by setting the balance to zero. In addition it will allow entities to avoid any adjustments to the balance which would be required as a result of the IFRS transition adjustments of foreign operations.

The Future of Foreign Exchange under IFRS

The International Accounting Standards Board (IASB) is currently not conducting any projects in relation to foreign exchange translations. However, the IASB has adopted an annual process to deal with non-urgent but necessary amendments to IFRS (the 'annual improvements process'). Therefore, while no major changes are expected, some minor changes may be made to the standard prior to 2011.

Conclusion

In general, the principles related to the translation of foreign currency transactions and translation of foreign operations under Canadian GAAP and IFRS have some similarities. However there are also some clear differences especially in relation to the approach taken by each in making the translation from a foreign currency to a measurement, functional or reporting currency.

If you require further guidance on foreign currency translations under IFRS or any other IFRS information or reference sources, please contact your local BDO Dunwoody LLP office or visit www.bdo.ca/ifrs.