INTERNATIONAL ACCOUNTING STANDARDS BOARD®

Draft Technical Correction 1

DTC 1 Proposed Amendments to IAS 21 *The Effects of Changes in Foreign Exchange Rates* Net Investment in a Foreign Operation

Comments to be received by 31 October 2005

This draft Technical Correction 1 – Proposed Amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates—*Net Investment in a Foreign Operation* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IAS 21. Comments on the draft Technical Correction should be submitted in writing so as to be received by **31 October 2005**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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Background

1 In December 2003 the International Accounting Standards Board issued improvements to various Standards, including IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

2 A principle in IAS 21 is that exchange differences arising on a monetary item that is, in substance, part of the reporting entity's net investment in a foreign operation are initially recognised in a separate component of equity in the consolidated financial statements of the reporting entity. Among the revisions to IAS 21 made in 2003 was the provision of guidance on this principle. The guidance required the monetary item to be denominated in the functional currency of either the reporting entity or the foreign operation. The previous version of IAS 21 did not include such guidance.

3 After the revised IAS 21 was issued, constituents raised several concerns (see paragraph BC4).

4 This draft Technical Correction addresses those concerns.

Invitation to Comment

The International Accounting Standards Board invites comments on the amendments to IAS 21 proposed in this draft Technical Correction, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated

(b) indicate the specific paragraph or group of paragraphs to which the comments relate

(c) contain a clear rationale

(d) include any alternative the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on additional issues related to the draft Technical Correction.

The Board is not seeking comments on matters in IAS 21 other than those set out in this draft Technical Correction.

Respondents should submit comments in writing by **31 October 2005**.

Question 1

Do you agree with the proposals in this draft Technical Correction? If not, why not? What changes do you propose and why?

Question 2

Do you have any other comments on the proposals?

Proposed Amendments to IAS 21
The Effects of Changes in Foreign Exchange Rates

An entity shall apply the amendments in this [draft] Technical Correction retrospectively with immediate effect.

Net investment in a foreign operation

Paragraph 15 of IAS 21 is amended as follows (new text is underlined and deleted text is struck through). Paragraphs 15A and 15B are added.

15 ~~An~~ A reporting entity or any of its subsidiaries may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation and is accounted for in accordance with paragraphs 32 and 33. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

15A For example, a reporting entity has two subsidiaries, A and B. Subsidiary B is a foreign operation. Subsidiary A grants a loan to Subsidiary B. Subsidiary A's loan receivable from Subsidiary B would be part of the reporting entity's net investment in Subsidiary B if settlement of the loan is neither planned nor likely to occur in the foreseeable future. This would also be true if Subsidiary A were itself a foreign operation.

15B An associate may be a foreign operation. A reporting entity or any of its subsidiaries may have a receivable from such an associate that is, in substance, part of the net investment in that foreign operation, if it meets the condition in paragraph 15. A monetary item that is payable to an associate by the reporting entity or any of its subsidiaries shall not form part of the reporting entity's net investment in a foreign operation.

Recognition of exchange differences

Paragraph 33 of IAS 21 is amended as follows (new text is underlined and deleted text is struck through).

33 When a monetary item forms part of a reporting entity's net investment in a foreign operation and is denominated in the functional currency of the reporting entity, an exchange difference arises in the foreign operation's individual financial statements in accordance with paragraph 28. ~~Similarly, i~~If such an item is denominated in the functional currency of the foreign operation, an exchange difference arises in the reporting entity's separate financial statements in accordance with paragraph 28. If such an item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, an exchange difference arises in the reporting entity's separate financial statements and in the foreign operation's individual financial statements in accordance with paragraph 28. Such exchange differences are reclassified to the separate component of equity in the financial statements that include the foreign operation and the reporting entity (ie financial statements in which the foreign operation is consolidated, proportionately consolidated or accounted for using the equity method). ~~However, a monetary item that forms part of the reporting entity's net investment in a foreign operation may be denominated in a currency other than the functional currency of either the reporting entity or the foreign operation. The exchange~~

~~differences that arise on translating the monetary item into the functional currencies of the reporting entity and the foreign operation are not reclassified to the separate component of equity in the financial statements that include the foreign operation and the reporting entity (ie they remain recognised in profit or loss).~~

Appendix
[Draft] Amendments to IAS 28

An entity shall apply the amendments in this [draft] Appendix retrospectively with immediate effect.

A1 In IAS 28 *Investments in Associates*, paragraph 29 is amended as follows (deleted text is struck through):

29 If an investor's share of losses of an associate equals or exceeds its interest in the associate, the investor discontinues recognising its share of further losses. The interest in an associate is the carrying amount of the investment in the associate under the equity method together with any long-term interests that, in substance, form part of the investor's net investment in the associate. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate. Such items may include preference shares and long-term receivables ~~or loans~~ but do not include trade receivables~~, trade payables~~ or any long-term receivables for which adequate collateral exists, such as secured loans. Losses recognised under the equity method in excess of the investor's investment in ordinary shares are applied to the other components of the investor's interest in an associate in the reverse order of their seniority (ie priority in liquidation).

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the proposed amendments to IAS 21.

Background

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Draft Technical Correction 1 − Proposed Amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates—*Net Investment in a Foreign Operation*. Individual Board members gave greater weight to some factors than to others.

The rationale for the proposed amendments

BC2 The principle in paragraph 32 of IAS 21 is that exchange differences arising on a monetary item that is, in substance, part of the reporting entity's net investment in a foreign operation are initially recognised in a separate component of equity in the consolidated financial statements of the reporting entity. Among the revisions to IAS 21 made in 2003 was the provision of guidance on this principle that required the monetary item to be denominated in the functional currency of either the reporting entity or the foreign operation. The previous version of IAS 21 did not include such guidance.

BC3 The requirements can be illustrated by the following example. Parent P owns 100 per cent of Subsidiary S. Parent P has a functional currency of UK sterling. Subsidiary S has a functional currency of Mexican pesos. Parent P grants a loan of 100 US dollars to Subsidiary S, for which settlement is neither planned nor likely to occur in the foreseeable future. IAS 21 requires the exchange differences arising on the loan to be recognised in profit or loss in the consolidated financial statements of Parent P, whereas those differences would be recognised initially in equity in the consolidated financial statements of Parent P, if the loan was denominated in sterling or Mexican pesos.

BC4 After the revised IAS 21 was issued in 2003, constituents raised the following concerns:

(a) It is common practice for a monetary item that forms part of an entity's investment in a foreign operation to be denominated in a currency that is not the functional currency of either the reporting entity or the foreign operation. An example would be a monetary item denominated in a currency that is more readily convertible than the local domestic currency of the foreign operation.

(b) An investment in a foreign operation denominated in a currency that is not the functional currency of the reporting entity or the foreign operation does not expose the group to a greater foreign currency exchange difference than arises when the investment is denominated in the functional currency of the reporting entity or the foreign operation. It simply results in exchange differences arising in the foreign operation's individual financial statements and the reporting entity's separate financial statements.

(c) It is not clear whether the term 'reporting entity' in paragraph 32 of IAS 21 should be interpreted as the single entity or the group comprising a parent and all its subsidiaries. As a result, constituents questioned whether the monetary item must be transacted between the foreign operation and the reporting entity, or whether it could be transacted between the foreign operation and any member of the consolidated group, ie the reporting entity or any of its subsidiaries.

BC5 The Board noted that the nature of the monetary item referred to in paragraph 15 of IAS 21 is similar to an equity investment in a foreign operation, ie settlement of the monetary item is neither planned nor likely to occur in the foreseeable future. Therefore, the principle in paragraph 32 of IAS 21 to recognise exchange differences arising on a monetary item initially in a separate component of equity effectively results in the monetary item being accounted for in the same way as an equity investment in the foreign operation when preparing consolidated financial statements. The Board concluded that the accounting treatment in the consolidated financial statements should not be dependent on the currency in which the monetary item is denominated, nor should it be dependent on which entity within the group transacts with the foreign operation.

BC6 Accordingly, the Board decided to propose an amendment to IAS 21. The proposed amendment requires exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation to be recognised initially in a separate component of equity in the consolidated financial statements. This requirement applies irrespective of the currency of the monetary item and irrespective of whether the monetary item results from a transaction with the parent or with any of its subsidiaries.

BC7 The Board also decided to clarify that an investment by an associate of the reporting entity in a foreign operation is not part of the reporting entity's net investment in that foreign operation. Because the reporting entity does not control the associate's investment, it generally has no ability to control the terms and conditions of settlement of the associate's investment in a group entity.

