

Query No. 4

Subject: Accounting treatment of exchange variation arising in respect of foreign operations of the company held through a wholly owned foreign subsidiary company as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.¹

A. Facts of the Case

1. A public limited company (hereinafter referred to as the ‘company’), which is a wholly owned subsidiary of a listed Government company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India. The company acquires oil and gas properties/ blocks by way of acquisition of Participating Interest (PI) either directly or through acquisition of shares of the legal entity owning the right in the oil and gas properties/ blocks. The overseas oil and gas operations are generally conducted in joint ventures with other partners. The company has PI in these joint ventures either directly or through acquisition of a company holding PI in the asset or through its overseas subsidiary. The PI of joint venture is held through subsidiary due to tax/ host country’s regulations, risk management perspective, etc.

2. The querist has stated that the company compiles its financial statements both on standalone and consolidated basis including the overseas subsidiaries in INR, following the requirements of the Companies Act, 2013, Accounting Standards and Guidance Notes, issued by the Institute of Chartered Accountants of India (ICAI). For the purpose of consolidation, all the subsidiaries prepare special purpose accounts, in accordance with Indian Generally Accepted Accounting Principles (GAAPs), converting to INR from their respective reporting currency.

3. As per the querist, the company has an overseas subsidiary (subsidiary A) for holding PI in some of its joint ventures. The functional currency of the subsidiary A is United States Dollars (USD). This subsidiary has a step-down subsidiary (subsidiary B) in another country. Subsidiary B holds certain PI in an oil and gas joint venture (joint venture) in the country of domicile. According to local regulatory requirements of the country wherein subsidiary B is registered and operating, the functional currency of subsidiary B is mandatorily the local currency, but for the purpose for consolidation of group accounts at subsidiary A level, the reporting currency is USD. The major part of the sales revenue of subsidiary B is received in USD and is kept in an offshore bank account in USD. The querist has informed that the joint venture in which subsidiary B has PI is a jointly controlled operation within the meaning of Accounting Standard (AS) 27, ‘Financial Reporting of Interests in Joint Ventures’ and the operations of joint venture are carried out in local currency only.

4. The querist has further stated that subsidiary A also holds equity in a joint venture company (JVC). The purpose of the JVC is to acquire, charter or lease equipment on one part and sell, charter or lease these assets on another part to facilitate the development and

¹ Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

production of hydrocarbons in the joint venture. The JVC is incorporated in the country of domicile of subsidiary A. The functional and reporting currency of JVC is USD.

5. As informed by the querist, there is a major transaction between JVC and the joint venture as follows:

The JVC (lessor) has entered into a long term lease agreement (viz., fifteen years) with the joint venture (lessee) for major oil field equipments like floating production storage and off-loading vessel (FPSO) and other sub-sea assets. These assets have been capitalised and recognised in the books of joint venture at lower of the fair value of the asset and the discounted value of the minimum lease instalments. The lease instalments are payable in USD and broken down into repayment of principal and interest components, based on a fixed interest rate and instalments derived from the underlying agreement. The lease commitments are carried and shown under long-term liabilities exclusive of interest in the books of joint venture. As informed by the querist, the lease payments are planned to be settled through periodic payments in USD by the joint venture to JVC. The structure of the relevant companies and joint ventures and transactions between them have been explained by the querist in Annexure 1.

The proportionate value of assets and liabilities of the joint venture is taken in the books of subsidiary B as per the principles laid down in AS 27 and recorded in the local currency, being the functional currency as per local regulatory requirements.

The querist has also informed that while compiling the consolidated financial statements of subsidiary A, the balance sheet items of subsidiary B are converted at the period end exchange rate and the profit and loss items of subsidiary B are converted at the average exchange rate for the period. The resulting exchange difference is transferred to the foreign currency translation reserve (FCTR), which is a part of 'Reserves & Surplus'.

6. As per the querist, subsidiary B operates with a substantial degree of autonomy and its day to day operations do not impact the cash flows of subsidiary A. The management and control of the subsidiary B are located in respective overseas jurisdiction. Further, the operations of subsidiary B are substantially managed from its own resources. The list of indicators as per paragraph 20 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', to test whether a foreign operation is an integral foreign operation or a non-integral foreign operation has been supplied by the querist for the perusal of the Committee as Annexure 2. Considering these, subsidiary B is considered as a non-integral foreign operation of the subsidiary A.

7. As per the querist, since subsidiary B is a non-integral foreign operation for subsidiary A, paragraphs 15 and 16 of AS 11 would apply, which are reproduced as follows:

“15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise’s net investment in a non-integral foreign operation should

be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.

16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.”
8. The querist has also stated that the lease payables are recorded in local currency in the standalone accounts of joint venture which is then consolidated with the local currency accounts of subsidiary B. Being a monetary item, these lease payables are translated at the period end using a closing exchange rate between USD and the local currency. The resultant exchange difference is charged off to the statement of profit and loss. However, for the purpose of consolidation of subsidiary B accounts with subsidiary A, the same lease payables are restated in USD thereby generating exchange difference which is being taken to foreign currency translation reserve (FCTR). On the other hand, lease receivables in the form of FPSO and subsea assets in the JVC are also appearing in the subsidiary A's consolidated accounts. As per the querist, lease receivables and payables get knocked off with each other in subsidiary A's consolidated accounts, however, the exchange variation arising from the books of joint venture still exist in the consolidated statement of profit and loss.
9. The querist is of the view that these exchange differences arising on long-term lease payables (from local currency to USD) as on the balance sheet date are notional and do not have direct effect on the present and future cash flows of both subsidiaries A and B. The querist is also of the view that these long-term lease receivables in the form of FPSO and subsea assets in the JVC are, in substance, subsidiary A's net investment in subsidiary B. Accordingly, these exchange differences should be accumulated in a foreign currency translation reserve in the consolidated financial statements of subsidiary A until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraphs 15, 16 and 31 of AS 11. However, subsequently, the querist has also informed that since the finance lease is planned to be settled by periodic lease payments in USD by the JV to JVC, the provisions of AS 11 relating to 'net investment in non-integral foreign operation' are not applicable on long-term lease receivables.
10. The querist has also stated that the company, in the consolidated financial statements, has adopted paragraph 46A of AS 11, wherein exchange differences arising on long-term foreign currency monetary items, so far as they relate to the acquisition of a depreciable capital asset, can be capitalised. The text of paragraph 46A is reproduced as follows:

“46A. (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a “Foreign Currency Monetary Item Translation Difference Account” in the enterprise’s financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.”

The querist has also stated that subsidiary B has not been applying provisions of paragraph 46A of AS 11, while the same was followed in the books of the parent company since 2011.

B. Query

11. The querist has sought the opinion of the Committee in respect of the following matters:

- (i) Whether the accounting treatment of exchange differences arising on long-term lease obligations as per paragraphs 7 to 9 above is appropriate;
- (ii) Whether paragraph 46A can be applied in the particular case by subsidiary B, since the company has already opted the same for long-term foreign currency monetary items since 2012-13, and if yes, whether there will be any prior period implication;
- (iii) Whether there is any other appropriate accounting treatment/ disclosure in respect of exchange differences arising on long-term lease obligations.

C. Points considered by the Committee

12. The Committee has examined the queries in paragraph 11 above, purely from accounting point of view and, accordingly, has not evaluated the compliance or otherwise of the applicable laws and regulations since as per Rule 2 of the Advisory Service Rules of the Committee, the Committee does not answer issues that involve only interpretation of enactments. Similarly, the Committee has not evaluated any tax implications of the matters under consideration.

13. The Committee has examined the matter from the perspective of Indian Generally Accepted Accounting Principles (Indian GAAP). The Committee notes that the querist has referred to 'functional currency' at various places in the query. The Committee notes that AS 11 does not have the concept of 'functional currency', but is based on the concept of 'reporting currency'. AS 11 defines 'reporting currency' as "the currency used in presenting the financial statements". Based on the facts of the query, the Committee's understanding of the reporting currency of relevant entities is as below:

Sl. No.	Entity	Reporting currency
1.	Indian parent company	INR
2.	subsidiary A	USD
3.	subsidiary B	Local currency of the country of domicile (other than USD and INR)
4.	JVC (lessor)	USD
5.	joint venture (lessee)	Local currency of the country of domicile (same as subsidiary B)

The Committee has assumed that the determination of reporting currencies by the company, as above, is in accordance with the requirements of AS 11. The Committee also notes that the company has considered subsidiary B as non-integral foreign operation. The Committee has not examined this aspect as the querist has not raised this issue and, accordingly, assumes that the same is in accordance with the relevant requirements of AS 11.

14. The Committee notes that the joint venture has considered the asset acquired on lease from JVC as 'finance lease' and, accordingly, recognised a finance lease payable in its books of account. The Committee assumes that the said determination is in accordance with the requirements of Accounting Standard (AS) 19, 'Leases'.

15. The Committee notes that the finance lease payable is denominated in foreign currency (USD) since the reporting currency of joint venture is other than USD. The Committee also notes that the finance lease payable is in the nature of monetary item and is required to be translated to reporting currency by using the closing rate as at the reporting date in the books of joint venture. With regard to accounting treatment of resultant exchange difference, the Committee notes paragraphs 15 and 16 of AS 11 as reproduced in paragraph 7 above and paragraph 13 of AS 11, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), as follows:

“13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise’s monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.”

Considering the above, the Committee is of the view that the exchange differences should be recognised in the statement of profit and loss of joint venture and subsidiary B (to the extent of its share in the joint venture) in accordance with the requirements of paragraph 13 of AS 11 (as reproduced above). Further, in the financial statements of subsidiary A, since in the extant case, the finance lease receivables are planned to be settled on a periodic basis, the question of consideration of the finance lease receivables in the nature of a monetary item that, in substance, forms part of company A’s net investment in subsidiary B does not arise.

16. The Committee further notes that the exchange differences on finance lease payable recognised in the stand-alone financial statements of joint venture continue to reflect in the consolidated statement of profit and loss of subsidiary A (to the extent of subsidiary B’s share in joint venture). The issue under consideration is how to deal with this exchange difference considering the fact that the underlying finance lease receivable (to the extent of subsidiary A’s proportionate share in joint venture company) and finance lease payable (to the extent of subsidiary B’s share in joint venture) are eliminated on consolidation. In this regard, the Committee notes paragraph 29 of AS 11, as below:

“29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.” (Emphasis supplied by the Committee.)

In view of the above, the Committee is of the view that the exchange differences arising on finance lease payable in the stand-alone books of joint venture would continue to be recognised in the consolidated statement of profit and loss of subsidiary A (to the extent of subsidiary B’s share in joint venture), even though the underlying finance lease payable

(to the extent of subsidiary B's share in joint venture) is eliminated against the finance lease receivable.

17. With regard to applicability of paragraph 46A to the present case, based on the facts of the query, the Committee is of the view that the finance lease installments that are scheduled to be paid on or after one year from the date the finance lease qualifies for recognition in the books of account are in the nature of long-term monetary item and, hence, paragraph 46A is applicable to the said item. In this regard, the Committee also notes the following guidance issued by Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI), in the form of Frequently Asked Questions on AS 11 notification - Companies (Accounting Standards) Amendment Rules, 2009 (G.S.R. 225 (E) dt. 31.3.09) issued by Ministry of Corporate Affairs:

“(13) If the long term foreign currency monetary item is received in instalments whether the installment received within a period of 12 months should be treated as short term in nature?”

Response

Yes, each loan installment should be treated as a separate monetary item. The principle should be to amortise the exchange difference proportionately over the period of the monetary item and not to carry forward any unamortised amount beyond the settlement of the monetary item to which the exchange difference relates. Treating the entire loan as a single monetary item would result in the exchange difference relating to the loan instalment which is settled being amortised in accounting periods even after such settlement.”

In view of the above, paragraph 46A should be applied to the long-term portion of finance lease payable by the joint venture.

18. The Committee also notes that as per the querist, paragraph 46A is being applied by the Indian parent company but not by subsidiary B. In this regard the Committee notes the following paragraph of Accounting Standard (AS) 21, ‘Consolidated Financial Statements’, notified under the Rules:

“20. Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.”

In view of the above, the Committee is of the view that the company should have applied paragraph 46A to subsidiary B as well while preparing its consolidated financial statements. In view of this, the impact of not applying paragraph 46A by subsidiary B in past in the context of consolidated financial statements, should be considered as prior

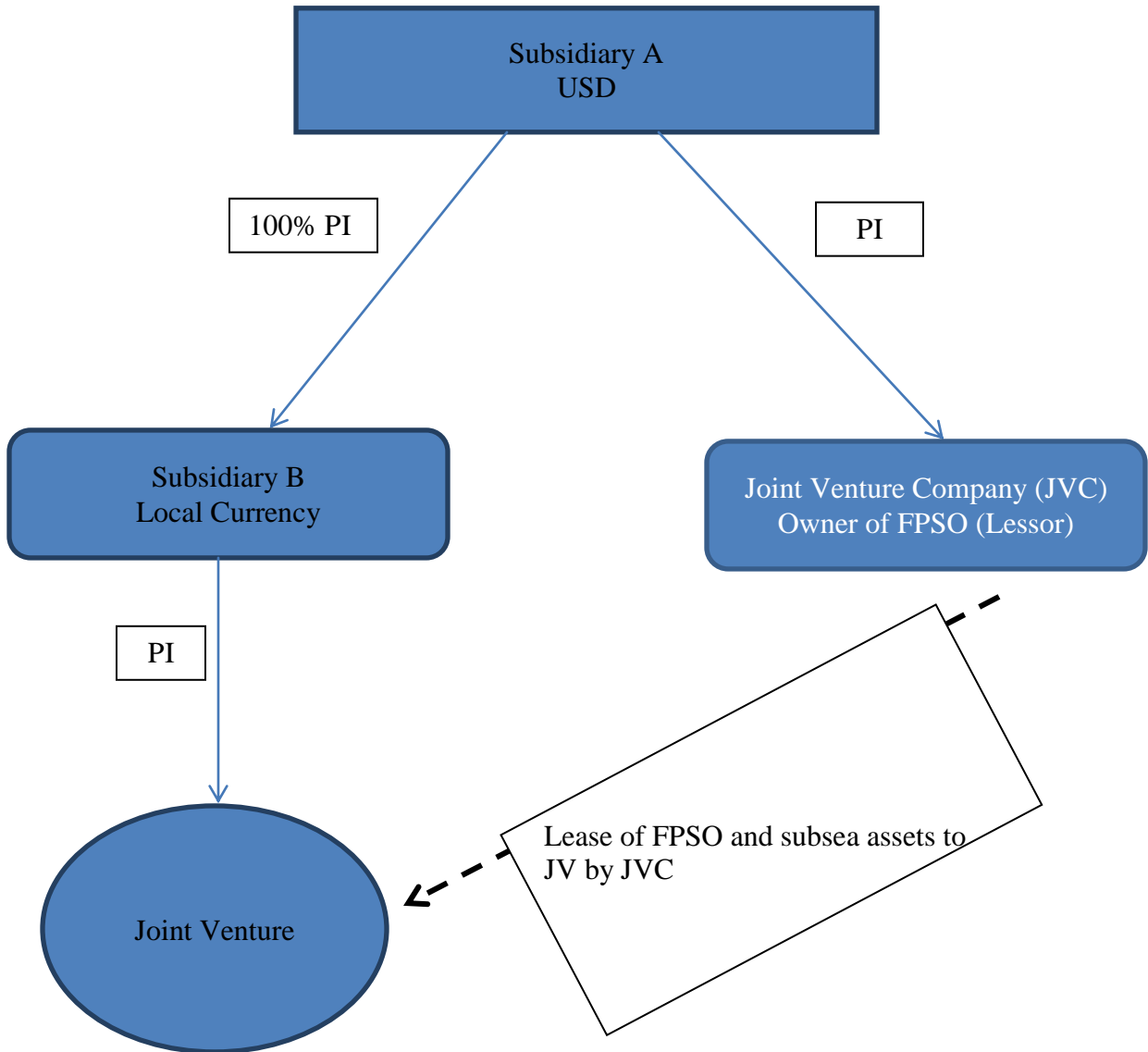
period item and should be dealt with in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

D. Opinion

19. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 11 above:

- (i) The accounting treatment of exchange differences on long-term lease obligations, as referred to in paragraphs 7 to 9 above, is not appropriate. In the financial statements of subsidiary A, since the finance lease receivables are planned to be settled on a periodic basis, the question of consideration of the finance lease receivables in the nature of a monetary item that, in substance, forms part of company A's net investment in subsidiary B does not arise, as discussed in paragraph 15 above. Further, the exchange differences arising on finance lease payable in the stand-alone books of joint venture would continue to be recognised in the consolidated statement of profit and loss of subsidiary A (to the extent of subsidiary B's share in joint venture), even though the underlying finance lease payable (to the extent of subsidiary B's share in joint venture) is eliminated against the finance lease receivable, as discussed in paragraph 16 above.
- (ii) The company should apply paragraph 46A to subsidiary B as well while preparing its consolidated financial statements as discussed in paragraph 18 above. Further, the impact of not applying paragraph 46A by subsidiary B in past in the context of consolidated financial statements, should be considered as prior period item and should be dealt with in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', as discussed in paragraphs 17 and 18 above.
- (iii) The accounting treatment for exchange differences arising on long-term lease obligation should be in accordance in paragraphs 15 to 18 above. Further, the disclosures should be in accordance with the requirements of AS 11.

Structure



Annexure-2

Particulars	subsidiary B
(a) 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;	Yes
(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;	Yes
(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;	No
(d) costs of labour, material and other components of the operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;	Yes
(e) the foreign operation's sales are mainly in currencies other than the reporting currency;	No
(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;	Yes
(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and	Yes
(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.	Yes
