Solution 6.1.

Component: Other (IAS 21)

Short title: Determination of the functional currency

Issue

Metals companies need to measure transactions in their functional currency even though their reporting currency is often the US dollar. How is the functional currency determined?

Solution

Management follows the guidance of IAS 21, "The effects of changes in foreign exchange rates" to determine the functional currency. This sets out primary and secondary indicators to help determine the entity's functional currency. Primary indicators must be given priority under IAS 21 over the secondary indicators. An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions [IAS 21.13].

Under IAS 21.8 there is a presumption that the currency of the environment in which the entity generates and spends cash is the functional currency. In addition the entity should consider the currency:

- that mainly influences sales prices for goods and services [IAS 21.9 (a)(i)];
- of the country whose competitive forces and regulations determine the sales price of its goods and services [IAS 21.9 (a)(ii)].
- that mainly influences labour, material and other costs of providing goods [IAS 21.9 (b)].

Other, less significant factors may also provide evidence as to the functional currency such as the currency in which an entity's operations are funded [IAS 21.10 (a)] and the currency in which receipts from operating activities are usually retained [IAS 21.10 (b)].

The fact is that for metals companies, particularly those that have international operations, the answer is often not obvious and therefore some judgment based on a detailed analysis of the situation is required.

For a related example please refer to the Appendix 6 "Determination of the functional currency".

Appendix 6 "Determination of the functional currency"

The following real life example led management to conclude that the entity's functional currency was the local currency even though its presentation currency was the US dollar.

Six months ended 30 June 23

	US$ million	Denominated in US$, %	Settled in US$, %
Revenues			
Export sales	700	100%	100%
Domestic sales	300	0%	0%
Total revenues	1,000	70%	70%
Costs and expense			
Materials and coal	420	20%	
Energy and gas	100		
Gas			
Personnel	70		
Other production expenses	40		
Depreciation (% of depreciation of items acquired through US$ denominated contracts)	50		
Selling, general and administrative expenses	50	18%	
Total operating expenses	**730**	**12%**	
CAPEX	**60**		
Dividends	**200**		

The following table represents major monetary assets and liabilities as of 30 June 2003:

	US$ million	Held in US$	Expressed in US$, %
Cash	100	80	
Trade accounts receivable	150	100	
Trade payables	120	–	0%
Borrowings	300	150	–

A thorough analysis such as summarized in the table above is required in order for management to make, and document, the basis for a judgment in this area.