Foreign currencies and accounting by charities

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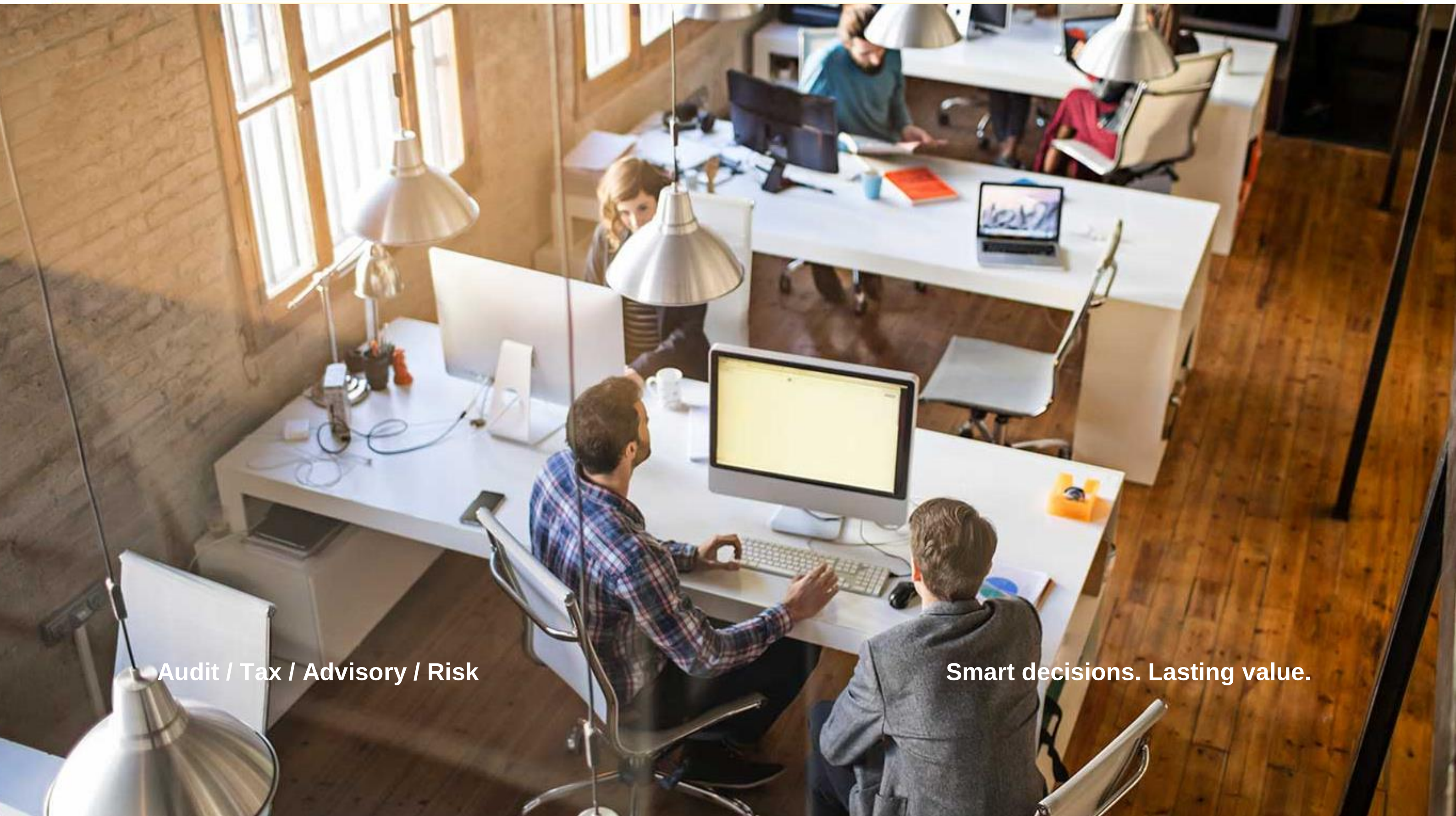

Increasingly UK charities find themselves involved with foreign currencies because some of their income or expenditure results from foreign operations and is in a currency other than GPB. The consequence of this is that transactions that are entered into in foreign currencies will need to be translated into GBP for financial reporting purposes.

There are two principal ways in which charities may carry out their work outside of the UK:

1. They may simply transact in a foreign currency by buying goods and services from overseas suppliers and/or by receiving funds in a foreign currency.
2. They may operate through overseas subsidiaries, branches or associates.

Section 30 of FRS 102, ‘Foreign Currency Translation’, sets out the basic accounting and reporting requirements for foreign currency transactions and the results of foreign operations, including the translation process whereby financial data denominated in one currency is expressed in terms of another currency.

For charities which use more complex hedging arrangements there are additional accounting requirements which may be relevant set out in Section 12 of FRS 102 ‘Other Financial Instruments Issues’. Additionally Section 31 of FRS 102 sets out the reporting requirements for an entity whose functional currency is the currency of a hyperinflationary economy. However, under the UK Generally Accepted Accounting Principles (UK GAAP), Section 30 of FRS 102 will be the applicable accounting standard for most charities and therefore this article focuses mainly on the application of this Section.

Application of Section 30 of FRS 102

Functional currency

The starting point for Section 30 is to determine the functional currency of the charity. The functional currency is the currency of the primary economic environment in which the charity operates, normally the one in which it primarily generates and expends cash. Factors which determine the functional currency may also include those that influence pricing of the charity’s services or the costs of labour, materials or other items used in providing these services.

The functional currency will commonly also be the currency which the charity uses to report its financial results - for most UK charities the functional currency is likely to be GBP although there are some UK charities which can have non-GBP functional currencies.

Key areas of foreign currency reporting

Having determined the functional/reporting currency there are two key areas of foreign currency reporting that charities may need to consider:

1. the translation of foreign currency transactions into the charity’s reporting currency
2. the translation of foreign currency financial statements of controlled overseas entities for consolidation purposes.

The different requirements of these two key areas are considered below.

Translation of foreign currency transactions into the charity's reporting currency

A foreign currency transaction is any transaction that is denominated, or requires settlement, in a currency other than the functional/reporting currency of the charity. For a charity this could involve a variety of transactions where the price/value is denominated in a foreign currency, including:

1. purchases and sales of goods and services
2. the acquisition of assets by the charity
3. taking on liabilities through grant commitments or loans.

The rules for accounting for such transactions are relatively simple and deal with the initial recognition of the transactions and then how they are reported at the end of subsequent reporting periods.

Initial Recognition

The Section 30 requirement is for any foreign currency transaction to be recorded initially in the reporting currency by translating the relevant foreign currency amount using the spot exchange rate between the charity's reporting currency and the transaction currency as at the date of the transaction.

Clearly using separate spot rates for individual transactions could be quite onerous and therefore for practical reasons where exchange rates do not fluctuate too significantly an average rate for possibly a week, or even a month, is commonly used for all of the foreign currency transactions occurring in each currency during that period.

Reporting at the end of the subsequent reporting periods

Having recorded foreign currency transactions that occur during a reporting period, a charity is likely to have related foreign currency denominated assets and liabilities which continue to be held at the period end. There are three different treatments of these assets and liabilities under Section 30 depending on the nature of the assets and liabilities.

1. Foreign currency monetary assets and liabilities, which are those that are either held or will be received or paid in foreign currency (for example debtors, creditors and cash), should be restated into the reporting currency using the applicable exchange rates as at the reporting date.
2. Non-monetary assets and liabilities that are reported at their historical cost (for example fixed assets, stocks and deferred income) should be reported using the applicable exchange rates as at the date of the original transactions that created the asset or liability (i.e. no subsequent retranslation of these assets or liabilities is normally required and they therefore continue to be recorded at historical cost).
3. Non-monetary assets and liabilities that are reported at their fair value at the reporting date (for example fixed asset investments in overseas equities/bonds) should be reported using the applicable exchange rate as at the reporting date.

Reporting of related exchange gains and losses

Exchange differences arising on the settlement of monetary items during a reporting or on the retranslation of monetary items at the reporting date should be reported with the relevant income or expenditure line on the charity's SoFA.

Exchange differences arising as part of the restatement of investments to their fair value (market value) at the reporting date should be reported as part of the gains and losses on investments within this separate line on the SoFA.

Whilst the above rules for translating foreign currency transactions are relatively simple, there can still be issues when applying the rules in practice. For example, there are often a variety of sources for exchange rates and these will generally all have some differences so there can be issues in determining an average rate or selecting an appropriate closing rate for the required translation.

Translation of foreign currency financial statements for consolidation purposes

The second key area to consider is for charities that have investments in overseas branches or subsidiaries which have a different functional/reporting currency to the parent charity. In this case it will be necessary to restate the income, expenditure, assets and liabilities of the overseas branches or subsidiaries into the reporting currency of the parent charity so that consolidated financial statements can be presented.

The accounting treatment for these overseas branches or subsidiaries will depend on whether or not they have a functional currency of a hyperinflationary economy. Specifically:

1. Section 30 of FRS 102 sets out the accounting requirements where the functional currency of the branch or subsidiary is not the currency of a hyperinflationary economy, and
2. Section 31 of FRS 102 applies to a branch or subsidiary whose functional currency is the currency of a hyperinflationary economy.

Where the functional currency <u>is not</u> the currency of a hyperinflationary economy

The foreign currency translation procedures for overseas branches or subsidiaries not in a hyperinflationary economy are as follows.

1. The assets and liabilities included in each Balance Sheet (i.e. including comparatives) should be translated using the applicable exchange rates at the date of the relevant Balance Sheet.
2. For each Statement of Financial Activities (i.e. including comparatives) the values of the recorded transactions should be translated at exchange rates at the dates of the relevant transactions.

As noted above for foreign currency transactions within the charity, clearly using different exchange rates for individual transactions could be quite onerous. It is therefore accepted that, for practical reasons where exchange rates do not fluctuate too significantly, the entity may use an exchange rate that approximates to the exchange rates at the dates of the transactions, for example by using an average rate for the period.

Reporting of related exchange gains and losses

The translation procedures above will result in exchange differences from:

1. translating income and expenditure at the exchange rates at the dates of the transactions but the related assets and liabilities at the rates at the Balance Sheet date
2. translating the opening net assets using the period end Balance Sheet exchange rates which will be different from the previous Balance Sheet rates.

These exchange gains and losses are as a result of the need to report in a single currency and do not form part of the group's net income or expenditure for the period. For a charity these exchange gains and losses should therefore be treated as a movement on the consolidated reserves and reported as other gains / losses which appear at the bottom of the Statement of Financial Activities.

Where the functional currency is the currency of a hyperinflationary economy

The foreign currency translation procedures for overseas branches or subsidiaries that operate in a hyperinflationary economy differ from the above in that all amounts (i.e. assets and liabilities, but also transactions recorded through the Statement of Financial Activities) should be translated at the applicable rates at the date of the Balance Sheet.

Additionally, Section 31 of FRS 102 requires certain of the non-monetary assets and liabilities held by the overseas entity at the reporting date together with the transactions reported in the Statement of Financial Activities to be restated by applying an appropriate price index such that they are expressed in terms of the prices current at the end of the reporting period.

Clearly this can be quite a complex process requiring a number of significant judgements, and it also requires certain additional disclosures on the basis for any indexation as well as any gains or losses on monetary items.

FRS 102 does not establish an absolute rate at which an economy is deemed to be hyperinflationary and this will therefore be a further judgement for the trustees. Any charity which has material operations reported in a currency of an economy which may be considered to be hyperinflationary will therefore need to carefully review the requirements in Section 31 of FRS 102.

Hedging transactions and ‘hedge accounting’

It is becoming increasingly common for charities to enter into foreign currency hedging transactions primarily to reduce risks associated with exchange rate movements. A diverse range of financial instruments, often referred to as derivative products, are available, the most common of which are forward exchange contracts and currency options.

For financial reporting, charities entering into such transactions may have the option to either apply or not apply ‘hedge accounting’, although applying hedge accounting will only be allowed if certain fairly complex conditions are met.

Assuming ‘hedge accounting’ is not used

If hedge accounting is either not an option or an option not applied then any assets or liabilities resulting from hedging transactions will be reflected within the charity’s financial statements following the accounting rules for other financial instruments as set out in Section 12 of FRS 102. These require the assets or liabilities to be valued at their fair values on initial recognition and again as at any subsequent reporting date, with any related gains or losses being recorded in the Statement of Financial Activities.

For a charity which enters into hedging transactions which approximately match recorded foreign currency denominated activity related assets or liabilities, the impact of this accounting should result in translation gains or losses relating to the activity related assets or liabilities being offset in the SoFA by revaluation losses or gains on the hedging transactions.

However, for a charity which takes out a hedging transaction to match an unrecognised commitment (such as a conditional future grant payment) or highly probable future transaction costs (such as the budgeted operating costs of an overseas branch), the requirement to report the hedging transaction financial instrument at its fair value as at any reporting date will result in unmatched revaluation gains or losses on the hedging transaction being included in the charity results reported in the SoFA.

If ‘hedge accounting’ is used

Charities may have an option to apply ‘hedge accounting’ but only if the hedging relationship meets a number of conditions which are set out in para 12.18 of FRS 102. It would also be necessary to understand the nature of the hedging relationship and whether it is a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation.

The impact of applying hedge accounting would be to move the related portion of any gains or losses on the hedging instrument out of the charities operating results and instead report this as a movement on the consolidated reserves. In practice this means moving it down to the bottom of the SoFA to be reported as part of any ‘Other gains and losses’.

Following the scenarios above, a charity which enters into hedging transactions which approximately match recorded foreign currency denominated activity related assets or liabilities is unlikely to benefit significantly from hedge accounting. But a charity which takes out a hedging transaction to match an unrecognised commitment or highly probable future transaction costs might consider that hedge accounting is a beneficial reporting option.

The application of hedge accounting is a complex area of accounting and is often considered more applicable to corporate entities where profit is a key performance measure. However, there may be circumstances where hedge accounting will be an appropriate option for charity – in these cases it will be important that the charity fully considers the requirements in Section 12 of FRS 102.

Hedge accounting disclosures

The application of hedge accounting would require a number of additional disclosures in the financial statements of the charity including on the charity’s relevant accounting policies. As an example, the following are accounting policy extracts from the WWF-UK published 2017 financial statements on Foreign Currencies, Financial Instruments and Hedge Accounting.

Foreign currencies

Transactions in foreign currencies are recorded either at the rate of exchange at the date of the transaction or, in the case of expenditure at the rate at which corresponding foreign currency income was recorded. Foreign currency balances have been translated at the rates of exchange ruling at the balance sheet date.

Financial instruments

WWF-UK has financial assets and financial liabilities of a kind that qualify as basic financial instruments. Basic financial instruments are initially recognised at transaction value and subsequently measured at the present value of future cash flows (amortised cost). Financial assets held at amortised cost comprise current asset investments, cash at bank and in hand, and the group’s debtors excluding prepayments. Financial liabilities held at amortised cost comprise the group’s creditors excluding deferred income. No discounting has been applied to these financial instruments on the basis that the periods over which amounts will be settled are such that any discounting would be immaterial.

Investments, including bonds and cash held as part of the investment portfolio, are held at fair value at the Balance Sheet date, with gains and losses being recognised within income and expenditure. Investments in subsidiary undertakings are held at cost less impairment.

WWF-UK enters into forward foreign currency contracts that do not qualify as basic financial instruments. These are held at fair value at the Balance Sheet date. Where hedging relationships are documented, they are accounted for using hedge accounting. Where the hedging relationship cannot be clearly documented, changes in fair value are recorded against the planned expenditure for the purchased currency.

Hedge accounting

WWF-UK enters into forward foreign currency contracts to hedge currency exposure on certain future expenditure. These are designated as hedging instruments in cash flow hedges. At the inception of the hedge relationship, the entity documents the economic relationship between the hedging instrument and the hedged item, along with its risk management objectives and clear identification of the risk in the item that is being hedged by the hedging instrument. Furthermore, at the inception of the hedge the Group determines and documents causes for hedge ineffectiveness. Note 19 sets out details of the fair values of the derivative instruments used for hedging purposes.

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in fair value movements on cash flow hedges. The gain or loss relating to the ineffective portion is recognised immediately in profit or loss. Amounts previously recognised in fair value movements on cash flow hedges and accumulated in equity are reclassified to profit or loss in the periods in which the hedged item affects profit or loss or when the hedging relationship ends.

Hedge accounting is discontinued when the Group revokes the hedging relationship, the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. Any gain or loss accumulated in equity at that time is reclassified to profit or loss when the hedged item is recognised in profit or loss. When a forecast transaction is no longer expected to occur, any gain or loss that was recognised in fair value movement on cash flow hedges is reclassified immediately to profit or loss.

Issues with the practical application of Section 30 of FRS 102 for charities

As the operating environment for charities in general, particularly for those operating overseas, has become more complicated so have the issues arising from the translation of foreign currency transactions.

Funders’ terms

Funders such as the EC set out clauses regarding translation rates in their funding agreements and use ‘published rates’ which are then the rates as set by the funder but which may differ from the actual rates experienced by the charity.

The following is an example of an EC grant clause:

“The contracting authority shall make payment in the currency of the country to which it belongs or in Euro....in the latter case any conversion into Euro of the real costs borne in other currencies shall be done at the rate published....In the event of an exceptional exchange rate fluctuation, the parties shall consult each other with a view to restructuring the action in order to lessen the impact of such a fluctuation.”

An issue may then arise when the published rate is different to the rate ruling at the time of the actual spend giving rise to exchange gains or losses.

For financial statement purposes, if a gain arises then that will be recorded as income in the SoFA and any loss as expenditure. However a further point to be considered is whether the gain, if any, is restricted or unrestricted. This will of course depend on the donor's terms but with respect to EC grants, the widely held view hereto has been that any gain or loss is borne by unrestricted funds.

The weakening of GBP in recent periods has meant that some charities in receipt of EUR have been exposed to foreign currency differences often not in their favour. There is now a trend towards holding foreign currency bank accounts to create a natural hedge against fluctuations. Some charities are also moving away from sending funds to their overseas branches or partners annually or six-monthly to monthly transfers based on actual expected expenditure thereby reducing foreign exchange differences that may arise.

Timing of donor reports and grant receipts

Another issue commonly arising is due to the timing of submission of the final donor reports. Typically donors such as the EU pay in instalments with a proportion of the total funding being only paid on submission and acceptance of the final reports.

The charity may therefore carry in its books an amount which is a 'true debt' and an amount which is work in progress which is in effect the amount waiting to be reported and invoiced/submitted to the donor. An issue can then arise when the charity is late in submitting the report such that by the time they receive the EUR the value in GBP is worth significantly more or less than that at which it had been recorded by the charity. The question which then arises is how the gain or loss should be recorded in the financial statements.

As can be seen from the accounting requirements summarised above, in any published financial statements any such gain or loss will be treated in the same way as the other gains or losses arising from the settlement of monetary assets. The impact of settling the amount owed from the donor at a rate well below that at which it is carried in the charity's accounts can be quite fundamental as the charity will now need to fund the 'loss' through its unrestricted funds. In our experience, quite often the impact of such items is not carefully considered or monitored through the monthly reporting systems. In a smaller charity with less readily available unrestricted funds the news of a loss of this nature can be quite a shock.

Use of budgeted or historical average rather than actual exchange rates

Some charities use a standard budgeted or historical average exchange rate rather than actual exchange rates at the date of transaction.

The impact of this can be to overstate or understate the GBP based expenditure which is nearly impossible to unpick at the year end. Furthermore there can be overstatement or understatement of the amounts charged to restricted funds if the expenditure is of a restricted nature. There are also wider issues with monthly management reporting such as the accuracy of those accounts, and with donor reporting.

Conclusion - Foreign Currencies and Accounting

Accounting for foreign exchange is an important topic and is often glossed over when preparing financial statement. As this article shows, there are specific rules that need to be followed and certain judgements, particularly on appropriate rates, to be made. It is therefore important to consider carefully the options and the basis for selecting and presenting the treatment. If, for example, the accounts show a 'book' loss or gain arising from year end retranslation, it is often useful to explain this.

As charities proactively manage their foreign currency transactions new disclosures are usually required and it is important to check that these have been made.

Notes

Start the conversation

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