



**Q What is functional currency? Why is the assessment of functional currency necessary?**

**A** In layman's term, the currency that is widely used (or transacted in) by a company in normal daily business is defined as the functional currency of the company. Nowadays, companies buy products from suppliers in different countries and trade with overseas customers to maintain competitiveness and increase their market share. This is a practical move for business. However, it also clouds the determination of functional currency.

Take for example, a company that buys and sells in United States dollars (USD), incurs operating

# FUNCTIONAL CURRENCY HIGHLIGHTS OF TECHNICAL CLINIC

In today's competitive business environment, it is common that companies do business with overseas suppliers and customers, or have overseas operations to take advantage of the lower costs and to achieve better margins. Such cross-border business activities inevitably result in companies having to trade in a variety of currencies. Most of the time, the management team involved in the daily operation of the business is not concerned with the assessment of the company's functional currency, and that creates a challenge for the auditor. We bring you some of the highlights of the technical clinic on functional currency, facilitated by Lim Yeong Seng, Managing Partner, Kong Lim & Partners LLP.



expenses in Singapore dollars (SGD), maintains operating receipts in USD and enters into transactions with its parent denominated in USD. If the management maintains the company's accounting records in SGD, the company's profit and loss will be affected by the translation of the USD transactions to SGD. The foreign exchange impact will contribute to the fluctuation of the company's financial results and may cause it to be misstated. Therefore, it is vital that management assesses and maintains its accounting records in its functional currency.

The auditor's role is to evaluate whether the functional currency determined by the management is reasonable and appropriate.

**Q Does a group have a functional currency?**

**A** A group does not have a functional currency. Each entity within the group is assessed separately for its functional currency, which is dependent on the economic environment the entity operates in and whether the entity is operating in autonomy from the parent company. For financial reporting purposes, management can choose the currency it wants to present its financial statements. The

management will then have to translate the financial statements of each entity to the group's presentation currency. The resulting exchange differences are recognised in other comprehensive income, that is, foreign currency translation reserve.

**Q Can a branch have a different functional currency from its head office?**

**A** Only in rare circumstances will a branch have a different functional currency from its head office. A branch is set up for a purpose and its activities are carried out on behalf of the head office. Therefore the branch is considered as an extension of the head office and should have the same functional currency as that of the head office.

There may be exceptions, for

EACH ENTITY WITHIN THE GROUP IS ASSESSED SEPARATELY FOR ITS FUNCTIONAL CURRENCY, WHICH IS DEPENDENT ON THE ECONOMIC ENVIRONMENT THE ENTITY OPERATES IN AND WHETHER THE ENTITY IS OPERATING IN AUTONOMY FROM THE PARENT COMPANY.

example, when management sets up a branch for tax planning purposes such that the branch is not required to remit its operating receipts to the head office and it operates with autonomy (that is, the branch determines the selling price of products). Hence, the functional currency for the

branch may be different from that of its head office.

**Q How does the auditor review and assess a company's functional currency? Will it suffice for the auditor to rely on the management's representations without challenging the appropriateness of the functional currency determined by the management?**

**A** Purely relying on the management's representation without further work done is not acceptable. The auditor needs to understand the company's business and its operations. The planning meeting with the management is a good time for the auditor to get an update on the changes to the company's operations, key customers or suppliers and other relevant details. Management may verbally conclude that the company's operations are the same as last year's and that there are no significant changes to customers or suppliers from prior year. The auditor will have to document the



understanding obtained in the notes to the planning meeting, and corroborate it with the work done during the audit field work.

The review of functional currency can be done in conjunction with the audit of profit and loss items, for example, review of the sales and purchases invoices files to check if transactions denominated in currencies other than the determined functional currency correspond to the weighted or composition represented by the management. The auditor can also perform analytical review of the currency denomination of the receivables and payables to identify inconsistency with the substantive testing performed for sales, purchases and expenses. For example, if the results of the substantive testing procedures performed for sales, purchases and expenses indicate that the company transacts mainly in SGD, it would be unusual if the receivables and payables are denominated in currencies other than SGD. The auditor should then make further enquiry, seek further clarification and perform additional audit procedures to conclude whether the unusual finding makes business sense and can be corroborated.

**Q How often should an auditor review the management's assessment of functional currency? Under what circumstances would a company have a change in functional currency issue? How should the auditor document and address the issue?**

**A** Regardless of how thoroughly the auditor had performed the assessment in prior years, the auditor is required to demonstrate that adequate work has been performed in every audit to conclude that the functional currency determined by the management is still appropriate.

The functional currency can be changed only if there is a change to the underlying transactions, events or circumstances of the company. An example would be a Singapore-incorporated company which used to import from its parent company in China and sold its products locally; it decided to manufacture the product in Singapore and also not rely on the parent company for funding by retaining its operating receipts in Singapore and not remitting it back to China. In this example, RMB was the functional currency of the company in prior years. This may not be the case in the current financial year from the date the company ceased to import from its parent company in China and commenced manufacturing the products in Singapore.

The auditor has to sight the agreement for the effective date of termination of imports from the parent company. Depending on whether the management intends to lease or build a manufacturing plant, the auditor should check for existence of the manufacturing plant by verifying to lease agreement or building contract. If the management intends to build a manufacturing plant, the change of functional currency may not be immediate. The auditor needs to identify when the company commenced manufacturing the products in Singapore by asking the right questions and requesting for appropriate supporting documents to substantiate the change in functional currency.

After doing all of the above, remember to document the work done. The work is not considered done until it has been documented.

**Q How should a company with a change in functional currency present its financial statements? Is there a need to restate prior-year figures?**

**A** We take the example discussed earlier to elaborate further. For example, the company's financial year-end is December and the management decided to change its functional currency from RMB to SGD with effect from 1 January 2013. The management will therefore translate all items in the statement of comprehensive income and statement of financial position into the new functional currency using the exchange rate at the date of the change on 1 January 2013. The resulting translated amounts for the non-monetary items are then treated as their historical costs.

The change in functional





currency as a result of changes in the company's operational environment is not a change in accounting policy and therefore there is no need for restatement of prior-year's financial statements, assuming no change to the company's presentation currency.

However, the use of presentation currency is a free choice and if the company decides to change its presentation currency as a result of the change in the company's functional currency, this is similar to a change in accounting policy. The company is then required to apply the change retrospectively, which means that the comparatives should be restated and presented using the new presentation currency.

**MOST OF THE TIME, THE MANAGEMENT TEAM INVOLVED IN THE DAILY OPERATION OF THE BUSINESS IS NOT CONCERNED WITH THE ASSESSMENT OF THE COMPANY'S FUNCTIONAL CURRENCY, AND THAT CREATES A CHALLENGE FOR THE AUDITOR.**

**Q The accounting standard requires a company to keep its accounting records in its functional currency. What happens if a company does not comply with the accounting standard? Is qualification a solution?**

**A** The auditor should request the management to comply with the required accounting standard and translate the accounting records to its functional currency.

The accounting standard requires monetary items to be

translated into the functional currency using the closing rate, and non-monetary items that are measured on a historical cost basis should be translated using the exchange rate at the date of the transaction.

Hence, if the company has mainly monetary assets, translation to its functional currency will be straightforward. Therefore, qualification is unlikely to be necessary.

In the case of a company with non-monetary assets, identifying the date of transaction may be a challenge depending on the nature of the non-monetary assets. If it involves fixed assets, the purchase dates could have been many years ago and it would be difficult to trace and determine the actual exchange rates for the respective dates of transactions. For non-monetary assets like inventories, determining the dates of transactions is also extremely challenging, given the large number of transactions.

However, there are ways to do it. The accounting standard allows the company to use an average rate for all foreign currency transactions occurring during the financial period, if the exchange rate does not fluctuate significantly. Hence, if the management is able to perform the translation and the auditor is able to evaluate the reasonableness and appropriateness of the exchange rates used by the management, qualification is also not necessary.

If the functional currency used is not correct, the financial statements are not being prepared in accordance with the applicable financial reporting framework and a modified audit opinion may have to be issued by the auditor. The choice of a qualified opinion or a disclaimer opinion is dependent on the financial impact of the non-compliance – whether it is material and pervasive to the overall financial statements. It is fair to say that the auditor should have explored or exhausted all possible solutions with the management before deciding to issue a modified audit report. The auditor should not consider modification of the audit opinion as the be-all and end-all solution. **CPA**

**By Magdalene Ang, Quality Assurance Manager, ICPAS**