Query No. 1

Subject: ***Accounting treatment of exchange variation arising on loan taken by foreign operations of the company held through a wholly owned foreign subsidiary company for the purposes of consolidated financial statements as per AS 11.***[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.

2. The querist has stated that 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 assets or through its overseas subsidiaries. The PI of joint venture is held through subsidiaries due to tax/ host country's regulations, risk management perspective, etc.

3. 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 GAAP, converting to INR from their respective reporting currency.* (Emphasis supplied by the querist.)

4. The company has an overseas subsidiary (subsidiary A) for holding PI in some of its joint ventures. This subsidiary A 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. The functional currency of subsidiary A is united states dollars (USD). 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 (local currency) and for the purpose of 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.

5. There is a major transaction between subsidiary A and subsidiary B as follows:

   Subsidiary A has advanced significant amount of loans in USD *under various loan agreements* to subsidiary B. The main part of a loan was towards purchase of an

[1] Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

additional PI in the existing Joint Venture. As per the terms of this loan agreement, the principal amount along with interest was required to be repaid within one year, subject to the availability of the funds with subsidiary B. Since, the utilisation of the said loan was to acquire oil fields, which take normally longer period for commercial operations, subsidiary B was not able to repay its dues on time and tenure of the loan has been extended time and again. Considering the liquidity position of subsidiary B and because the repayment of principal was not foreseeable to be paid in near future, part of the loan was converted into equity and the balance loan was extended for another period of 350 days thereby the total repayment period was about two years. Further, the loan agreements in respect of other loans which were due and payable were also extended time and again considering liquidity position of subsidiary B. As of now, the significant amount of loans is also not likely to be settled in the foreseeable future. (Emphasis supplied by the querist.)

6. The querist has stated that subsidiary B operates with a substantial degree of autonomy and its day to day operations do not impact subsidiary A. The management and control of subsidiary B is 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 1. Considering these, subsidiary B is considered as non-integral foreign operation of subsidiary A.

7. 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, which is part of 'Reserves & Surplus'.

8. According to the querist, as 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."

9. In case of outstanding loans due from subsidiary B to subsidiary A, though the repayment dates have been specified as per local regulatory requirements, the tenure has been extended time and again by subsidiary A. *As of now, the remaining loans are not likely to be settled in the foreseeable future and, therefore, the company is of the view that such loans are, in substance, an extension of the subsidiary A's net investment in subsidiary B as per paragraph 16 of AS 11. Further, recently a resolution has been passed wherein a major part of a loan has been extended by 1095 days with a clause for repayment on or after 5th April, 2016 based on the liquidity and cash flow position of subsidiary B.* (Emphasis supplied by the querist.)

10. The querist has also stated that sales revenue of subsidiary B is received in USD and kept in an offshore USD account. Whenever there is a requirement to meet payment obligations of subsidiary B in local currency, the requisite funds kept in the offshore USD account are converted into local currency and actual exchange loss/gain does not arise. Accordingly, exchange differences arising on outstanding loan (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 and, therefore, according to the querist, 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 paragraph 31 of AS 11.

11. The company, in the consolidated financial statements, has adopted paragraph 46 A of AS 11, wherein exchange differences arising on long-term foreign currency monetary items, in sofaras they relate to the acquisition of depreciable capital assets, 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."

B. Query

12. In view of the above facts, the opinion of the Expert Advisory Committee of the ICAI is sought on the following as to whether:

(i) 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 or not;

(ii) the accounting treatment of exchange differences arising on loan as per paragraphs 8 to 10 above is appropriate;

(iii) there is any other appropriate accounting treatment/disclosure in respect of exchange differences arising on loan.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to the accounting treatment of the exchange differences arising on outstanding loan taken by company B in question (which is subsidiary of company A) from company A for the purpose of incorporation of the same in the consolidated financial statements of the company in question (which is the parent company of company A and B) as per the principles of AS 11. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting treatment in the books of company A and company B as per the local GAAPs prevailing in the countries in which these companies are domiciled, accounting for the loans converted into equity and exchange differences arising on such part of loans, etc. At the outset, the Committee wishes to point out that the determination of appropriate classification of foreign operations into integral and non-integral is a matter of judgement considering the application of paragraphs 17 to 20 of AS 11 in the facts and circumstances of the company and since considering these paragraphs, company B has been considered as non-integral foreign operation in the books of company A, the Committee has not examined this issue and presumes that company B is a non-integral foreign operation for company A.

14. The Committee notes that the querist has referred to 'functional currency' at various places in the query. In this regard, the Committee wishes to point out that AS 11

does not follow the 'functional currency' concept and prescribes that the reporting currency should be used in recording foreign currency transactions and for presenting financial statements.

15. With regard to accounting treatment of the exchange differences arising on outstanding loan taken by company B (which is subsidiary of company A) from company A for incorporating the same in the consolidated financial statements of the parent company, the Committee notes paragraphs 15 and 16 of AS 11 as reproduced in paragraph 8 above and other requirements of AS 11, notified under the Companies (Accounting Standards) Rules, 2006, as follows:

> ***"11. At each balance sheet date:***
>
> ***(a) foreign currency monetary items should be reported using the closing rate. …***
>
> ***(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and***
>
> ***(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined."***
>
> ***"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."***
>
> ***"24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:***
>
> ***(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;***
>
> ***(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and***
>
> ***(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment."***

> "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."

From the above, the Committee notes that in case of non-integral foreign operations, for determining the accounting for the exchange differences on the loan amounts, there is a need to determine whether the loans to that foreign operation, in substance, form part of the company's net investment in that non-integral foreign operation or not. The Committee further notes from paragraphs 15 and 16 of AS 11 reproduced in paragraph 8 above that a monetary item that is receivable from a non-integral foreign operation is, in substance, an extension to the enterprise's net investment in that non-integral foreign operation if for such item, settlement is neither planned nor likely to occur in the foreseeable future. In this regard, the Committee notes that in the extant case, initially, company A had given dollar denominated loans to subsidiary B which were to be repaid within one year. Further, recently their tenure has been extended by 1095 days. From the above, the Committee is of the view although the tenure of such loans has been extended from time to time and although settlement of such loans is not expected in the foreseeable future, the repayment of such loans was always planned and, therefore, such loans/advances to subsidiary B cannot be treated as the company's net investment in non-integral foreign operation. Accordingly, the question of adjustment of foreign exchange differences on such loans to foreign currency translation reserve as per paragraphs 15 and 16 of AS 11 does not arise in the consolidated financial statements of subsidiary A or the Indian parent company. Further, in the financial statements of company B, the loan in USD, viz., foreign currency monetary item shall be reported at the closing exchange rate and the resultant exchange difference shall be recognised as expense or income in the statement of profit and loss (except in situations where paragraphs 46/46A of AS 11 are applied). While incorporating the financial statements of company B in the consolidated financial statements of the Parent company also, although the intra-group monetary items, viz., advances receivable in the financial statements of company A and advances payable in the financial statements of company B shall be eliminated, but considering the requirements of paragraph 29 of AS 11, as reproduced above, since monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations, exchange difference arising on an intra-group monetary item cannot be eliminated against a corresponding amount

arising on other intra-group balances and has to be recognized as income or expense in the consolidated financial statements of the reporting enterprise.

16. With regard to the issue whether subsidiary B can apply paragraph 46A of AS 11, the Committee notes that the situation of application of paragraph 46A of AS 11 would arise in the extant case only in the context of consolidated financial statements of the company. The Committee further notes that paragraph 46A is applicable only in relation to long-term monetary items. Therefore, the issue to be determined is whether the loans payable in the extant case can be considered as long-term loans for the purpose of accounting for exchange differences arising on monetary item translation as per paragraph 46A of AS 11. In this regard, the Committee notes paragraph 46A (2) of AS 11 as follows:

> "(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:
> ..."

From the above, the Committee notes that an asset or liability shall be designated as long term, if the asset or liability has a term of twelve months or more at the date of origination of the asset or liability. Since in the extant case, initially, from the date of origination of loan to the date when it falls due, the term is less than a year, though that term has been extended time and again considering the liquidity position of company B, the liability in the financial statements of company B cannot be designated as long-term liability and, therefore, the option available under paragraph 46A of AS 11 is not applicable to the company.

D. Opinion

17. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

(i) Paragraph 46A of AS 11 cannot be applied in the particular case by subsidiary B, as discussed in paragraph 16 above.

(ii) and (iii) The accounting for exchange difference arising on the outstanding loan to be accumulated in foreign currency translation reserve in the consolidated financial statements of company A for incorporating the same in the financial statements of the parent company is not correct. Same should be recognised as expense or income in the financial statements, as discussed in paragraph 15 above.

Annexure 1

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