Accounting treatment of exchange variation in respect of foreign operations of the company as per AS 11

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A public limited company, which is a wholly owned subsidiary of a listed Government company (hereinafter referred to as the '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) 100% or less therein 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 acquisition of a company holding PI in the asset or through its wholly owned overseas subsidiary companies. Main consideration for holding PI through subsidiary companies is because of tax or host country's regulations or risk management point of view.
2. The company compiles its financial statements both on standalone and consolidated basis including the overseas subsidiaries in INR, following the requirements of Companies Act and Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI). In respect of the overseas joint ventures directly held by the company, following procedure is followed for accounting for the company's share of expenditure:
   - The company pays its estimated share of expenditure at the beginning of every month to the operator of the project termed as cash calls which is accounted as advance payment.
   - The joint venture operator provides the periodic statement of expenditure which is considered for accounting for the company's share of expenditure in joint venture following Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures' on a line by line basis.
   - The company receives its share of oil and gas production from the joint venture and markets the same either directly on its own or jointly through other consortium partners and the revenue is accounted for in the normal course of operation following the provisions of Accounting Standard (AS) 9, 'Revenue Recognition'.

   Based on the above procedure, operations of such joint ventures are considered as 'Integral Foreign Operations' as per the criteria provided in Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates'. Subsequent to the initial recording of the company's share of expenditure, income, assets and liabilities in the joint venture, the monetary items denominated in foreign currency are revalued at the end of the period and the exchange difference arising out of such revaluation is transferred to the statement of profit and loss.
3. In respect of joint ventures/projects held through overseas subsidiaries, following procedure is followed for accounting for the subsidiary company's share of expenditure, income, assets and liabilities in the joint venture:
   - The overseas subsidiary operates with a substantial degree of autonomy over its operations and does not affect the day to day activities of the company. The management and control of the subsidiary is located in respective overseas jurisdiction.
   - Periodically, the share of profit is received from the overseas subsidiary in the form of dividends which is accounted for as income in the books of the company.
   - The financial statements of overseas subsidiaries are consolidated following the provisions of Accounting Standard (AS)

21 'Consolidated Financial Statements'. While compiling the consolidated financial statements of the company, the balance sheet items are converted at the period end exchange rate and the profit and loss items 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 and Surplus'.

Such overseas subsidiaries are considered as 'Non-integral Foreign Operations' as per the definition provided in AS 11.

4. The company is of the view that both types of foreign operations of the company are similar in substance but different in form, however for the same purpose. The only difference is the legal form of the operations, otherwise the operation through the subsidiary companies is essentially an extension of its direct operations. Thus, the accounting treatment as per AS 11 should not be different. As per the querist, there is separate accounting treatment for both types of foreign operations, which are in essence quite similar. The company is of view that both types of operations should be considered as 'integral foreign operations'.
5. As per paragraph 18 of AS 11, an integral foreign operation has been defined as the operation which carries on its business as if it were an extension to the reporting enterprise itself. The relevant paragraph of AS 11 has been reproduced below:

   "18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation."(Emphasis supplied by the querist.)

The Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, in paragraph 35 deals with 'substance over form' as one of the principles for reliability of financial statements. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. The principle of 'substance over form' is used "to ensure that financial statements give a complete, relevant, and accurate picture of transactions and events". If an entity practices the 'substance over form' concept, then the financial statements will show the overall financial reality of the entity (economic substance), rather than the legal form of transactions. In accounting for business transactions and other events, the measurement and reporting is for the economic impact of an event, instead of its legal form. Accordingly, as per the querist, considering 'substance over form' in the instant case, both types of operation should be treated as integral foreign operations as per the provisions of AS 11.

B. Query

6. In view of the above facts, the opinion of the Expert Advisory Committee of the ICAI is sought on the following issues:

(i) Whether the current accounting treatment of foreign operations of the company carried on through joint ventures held directly or through overseas subsidiary as per AS 11 is appropriate; or

(ii) Whether there is any other appropriate accounting treatment/disclosure in respect of foreign operations of the company.

(iii) Whether the company can treat the operations conducted through overseas subsidiaries as integral foreign operations as per AS 11.

(iv) If the company has to treat the subsidiary companies as integral foreign operations as stated in point (iii) above, what will be the accounting treatment of the exchange variation in 'Foreign Currency Translation Reserve' till

the date of switch over to 'Integral Foreign Operation'?

(v) Is there any need for revision of the relevant Accounting Standards to provide for the extant situation and to adhere to the basic accounting principle or substance over form?

C. Points considered by the Committee

7. The Committee notes that the basic issue relates to appropriateness of accounting treatment of the foreign operations of the company carried on through participating interest in joint operations with other partners, which is termed by the querist and hereinafter referred to as 'joint venture', held directly or through overseas subsidiary as per 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, classification of joint operations with other partners as 'joint venture' and accounting for the company's share of expenditure, income, assets and liabilities in such joint venture as per AS 27, accounting for share of oil and gas production from joint venture, recognition of share of profit received in the form of dividend from the overseas subsidiary company, consolidation of financial statements of subsidiary companies as per AS 21, use of average exchange rate for the period for translating the items of statement of profit and loss of the foreign subsidiary companies, etc.

8. The Committee is of the view that the accounting treatment of foreign operations of the company carried on through joint ventures held directly or through overseas subsidiary as per AS 11 would depend upon whether the foreign operations are integral or non-integral to the operations of the company. In this regard, the Committee notes the definitions of 'integral foreign operation' and 'non-integral foreign operation', and paragraphs 18 to 20 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates,' notified under the Companies (Accounting Standards) Rules, 2006 as follows:

> ***"7.10 <u>Integral foreign operation</u> is a foreign operation, the activities of which are an integral part of those of the reporting enterprise."***

> ***"7.13 <u>Non-integral foreign operation</u> is a foreign operation that is not an integral foreign operation."***

"18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

(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;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(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;

(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

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification."

From the above, the Committee is of the view that classification of a foreign operation into integral or non-integral requires judgement in the specific facts and circumstances which takes into consideration the substance of the situation. Accordingly, if two foreign operations are similar in substance in the way these are financed or operate in relation to the reporting enterprise, these would be classified similarly (viz., integral or non-integral) as per the principles of AS 11. It is not the legal form, viz., subsidiary or joint venture that determines the classification under AS 11. If the operations of a subsidiary company are being carried out as if it were an extension of the company, the operations of even a subsidiary company would be classified as integral foreign operations. AS 11 nowhere states that the operations of a subsidiary company should essentially be classified as 'non-integral foreign operations' even when it is carrying operations as an extension of the holding company. This is also clear from the requirements of the Standard pertaining to 'change in the classification of a foreign operation' which states that a change in the way in which foreign operation is financed and operates in relation to the reporting enterprise (viz., substance) may lead to a change in the classification of foreign operation. Thus, it is possible that without a change in the legal form, an integral foreign operation may be reclassified as non-integral foreign operation and vice versa.

9. The Committee notes from the Facts of the Case that the querist has stated that the overseas subsidiary operates with a substantial degree of autonomy over its operations and does not affect the day to day activities of the company and that the management and control of the subsidiary is located in respective overseas jurisdiction. However, the Committee is of the view that this information is not sufficient to determine the classification of foreign operations as per the above-reproduced paragraphs of AS 11 and other factors as specified in AS 11 should also be considered. Determination of classification is a judgemental issue considering the facts and circumstances specific to the company in the light of the requirements of AS 11. The Committee is, therefore, of the view that the company should apply the criteria specified in the above paragraphs in its own facts and circumstances to determine whether the foreign operations of joint venture held directly or through overseas subsidiary are integral or non-integral.

10. After classification of foreign operation as discussed above, the Committee is of the view that accounting treatment should be followed accordingly, as per the provisions contained in

the AS 11. In this regard, the Committee is of the view that after considering the above criteria, if it is determined that foreign operations of the company carried on through joint ventures held directly by the company, are integral foreign operations as per AS 11, then the accounting treatment as followed by the company is appropriate, otherwise it is not appropriate. Similarly, after considering the above criteria, if it is determined that foreign operations of the company carried on through a subsidiary of the company, are non-integral foreign operations as per AS 11, then the accounting treatment as followed by the company is appropriate, otherwise it is not appropriate.

11. With regard to the issue raised by the querist regarding the accounting treatment of the exchange variation in 'Foreign Currency Translation Reserve' till the date of switch over to integral foreign operation if the company has to treat the foreign operations conducted through the subsidiary companies as integral foreign operations, the Committee is of the view that if, facts and circumstances remaining the same, by considering the above criteria, it is determined that the foreign operations conducted through subsidiary company are integral foreign operations and not non-integral foreign operations, then it is an error in the preparation of the financial statements of earlier years and, therefore, it is a 'prior period item' as per Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. Accordingly, the company should rectify its error of prior accounting periods by making appropriate changes in the current reporting period by treating it as a 'prior period item' as per the provisions of AS 5.

D. Opinion

12. On the basis of the above, the Committee is of the following opinion in respect of the issues raised by the querist in paragraph 6 above:

(i) and (ii) The appropriateness of accounting treatment of foreign operations of the company carried on through joint ventures held directly or through overseas subsidiary as per AS 11 would depend upon the classification of foreign operations as integral or non-integral foreign operations as per the provisions of AS 11, as discussed in paragraphs 8, 9 and 10 above.

(iii) The operations conducted through overseas subsidiaries can also be treated as integral foreign operations if the operations of a subsidiary company are being carried out as if it were an extension of the company as per the criteria of AS 11, as discussed in paragraph 8 above.

(iv) If after considering the above criteria as discussed in paragraphs 8 and 9 above, it is determined that the foreign operations conducted through subsidiary company are integral foreign operations and not non-integral foreign operations, then as discussed in paragraph 11 above, it is an error in the preparation of the financial statements of earlier years, and therefore, it is a prior period item as per AS 5.

(v) Since AS 11 adequately addresses the issue involved in the extant case, answer to this question does not arise.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on December 11, 2014. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty two volumes. A CD of Compendium of Opinions containing thirty two volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.