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EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES IN INTERNATIONAL ACCOUNTING STANDARDS AND IN POLISH ACCOUNTING REGULATIONS

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Key words: exchange differences, international accounting standards, accounting act.

Abstract

This paper tackles the problem of exchange differences in International Accounting Standards and in the Polish Accounting Act. It presents a brief history of standardization in accounting and describes regulations that oblige economic entities to comply with the international standards. The main part of the article focuses on differences regarding the general approach of the Accounting Act compared to the IAS. It takes into scrutiny issues regarding the recognition of exchange differences and presents the use of specific exchange rates during the process of translation.

RÓŻNICE KURSOWE W MIĘDZYNARODOWYCH STANDARDACH RACHUNKOWOŚCI I W USTAWODAWSTWIE POLSKIM

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Słowa kluczowe: różnice kursowe, Międzynarodowe Standardy Rachunkowości, ustawa o rachunkowości.

Abstrakt

W artykule poruszono problem różnic kursowych w Międzynarodowych Standardach Rachunkowości i w polskiej ustawie o rachunkowości. Zarysowuje historię standaryzacji w rachunkowości. Opisuje wymogi dotyczące stosowania międzynarodowych standardów. Główna część artykułu skupia się na opisaniu różnic w podejściu do tematu różnic kursowych ustawy o rachunkowości i MSR. Rozważano kwestie uznawania różnic kursowych i prezentuje stosowanie różnych kursów walutowych do przeliczeń.

Introduction and the aim of search

The article concerns the exchange rate differences in International Accounting Standards, mainly in IAS 21 “Effects of Changes in Foreign Exchange Rates” and in the Polish Accounting Act. This issue has been tackled by few authors since the amendment of the Polish Accounting Act in the year 2008 and was treated in a general way. The aim of this article is to explain the discrepancies between the IAS and the Polish Accounting Act in the case of exchange differences. The main goal is to present the most significant differences between the Accounting Act and the IAS such as the problem of the approach of the Polish law and international regulations towards this issue and the problem of recognition of exchange differences.

Methodology of studies

The research method consisted of studying the literature on the subject of exchange differences. The study mainly focuses on the text of the Polish Accounting Act before and after the amendment dated on 18th March 2008 and IAS 21 “Effects of changes of the exchange rates”. Corresponding paragraphs have been compared in the view of the effects for business entities. The obtained discrepancies are described and presented in a table.

Standardization in Accounting

Easy access to reliable and credible information during the times of increasing global convergence and acceleration of the process of tightening ties between international economic entities is of vital importance when economic decisions are being taken. Information included in financial statements is indispensable in the analysis of the financial situation of business entities. Therefore, it should be subject to common and unified rules regardless where it has been prepared (TURYNA 2003, p. 18).

Standardization in the international and regional scale leads to increasing comparability and clarity of financial statements owning to common assumptions, standards, and concepts with, nevertheless, a certain amount of flexibility left. Intensive promotion of unified standards and the beginning of their application commenced when the International Accounting Standards Committee (IASC) has been founded in June 1973 in London (JARUGA 2002, p. 3). IASC was started by chartered accountans’ organizations from Australia, Canada, France, Germany, Japan, Mexico, Holland, Great Britain, United States and Ireland (CEBROWSKA 2007, p. 133).

From 1973 to 2002 the IASC developed and published nearly 40 standards and 24 interpretations dedicated to various issues of accountancy and financial reporting (TURYNA 2003, p. 10). In 2001 IASC has been restructured and transformed into International Accounting Standards Board – IASB (CEBROWSKA 2007, p. 133). The headquarters have been moved from London to Delaware US. The new organization assumed the responsibilities of its predecessor.

Obligation of using the IAS

The obligation of using International Accounting Standards varies between countries. In Poland the Polish Accounting Act is superior towards National Accounting Standards and International Accounting Standards, however in matters not regulated by the Accounting Act it is possible to use International Accounting Standards. However, it should be remarked that many countries have adopted the IAS as national accounting standards.

The IAS are used:

– as the basis of national requirements of accountancy in many countries.

– by the stock exchange – the IAS are used to prepare financial statements by national companies and companies from abroad.

– by international organizations (OLCHOWICZ, TŁACZAŁA 2004, p. 15).

According to the requirements of the European Commission, all EU companies that are listed on the stock exchange have been obliged to prepare their financial statements according to the IAS since 2005. However, in the case of companies that are not listed on the stock exchange, the decision whether to prepare the financial statement according to the IAS lies within the competence of national law (CEBROWSKA 2007, p. 134).

According to article 55 of the Accounting Act, banks and entities operating in the European Economic Area are obliged to use the IAS. Entities which are forming a capital group in which the dominating entity prepares the consolidated financial statement according to the IAS and entities that plan to issue securities are allowed to use the IAS. However, when an entity is on the regulated market of the EEA it is obliged to prepare its financial statement according to the rules presented in the IAS. Furthermore, the manger of the entity should take into account the fact that a financial statement prepared according to the IAS is submitted to an obligatory audit.

Exchange differences in the IAS

IAS 21 “Effects of Changes in Foreign Exchange Rates” regulates the exchange differences. However, some rules are also listed in IAS 23 regarding costs of external financing and in IAS 12 regarding the deferred tax asset. Exchange rates connected with securities are regulated by IAS 38.

IAS 21 regulates the ways of evaluation and presentation of assets and liabilities in foreign currency and procedures of translating the transactions expressed in foreign currency (JARUGA 2004, p. 167).

The standard should be used when:

a) recognizing in the financial books transactions made in foreign currencies.

b) translating financial statements of entities performing business activities abroad which are included in the financial statement of the dominating entities in full or in proportional consolidation method or in the equity method.

c) translating results and balances to the presentation currency.

The standard presents a division into functional and presentation currency. The functional currency meets the following criteria:

– it strongly influences the prices of goods and services.

– it is the currency of the country which economic environment and regulations strongly influence the prices of goods and services.

– it influences in the strongest way the costs of labor, materials and other costs connected with sold goods and services (HELIN 2006, p. 350).

Whereas the presentation currency is the currency in which the financial statement is published.

Differences between the approach of the IAS and the Polish Accounting Act to exchange differences

Transactions in foreign currencies are translated to Polish Zloty at various moments and in different goals. The rules of translation are set in the Polish law in the Accounting Act, in the Corporate Income Tax Act, in the VAT regulations and in the international regulations set in the IAS. Given the fact that these rules were designed for different purposes there are some differences between them (RUDNICKA 2005).

In the case of exchange differences it is important to notice that the IAS 21 has been designed to allow recognizing transactions in foreign currencies and translating financial statements of entities operating abroad. The recommendations expressed in the standard are sometimes rather general, which is motivated by the fact that the standard should be universal. The Accounting Act regulates the issues of exchange differences in much greater detail (JARUGA 2004, p. 167).

The major difference between the IAS and the Polish Accounting Act is that according to the IAS a financial statement should be done in the presentation currency which is not necessarily the currency of the country in which the entity has its headquarters. The Polish Accounting Act demands financial statements to be done in the Polish language and in Polish Zloty (HELIN 2006, p. 353).

Furthermore, it can be said that the IAS are more flexible regarding the type of exchange rate to be used in the translation. According to the standard foreign transactions should be shown in the functional currency according to the exchange rate valid for the day of the transaction, which is usually the spot exchange rate. Yet, the standard allows, due to practical reasons, the use of average exchange rates if the average exchange rate can be considered as reliable (JARUGA 2004, p. 167).

However, the article 30.2 of the Accounting Act states that transactions in foreign currencies should be recognized on the same day that they have taken place at the exchange rate that was used, or the average exchange rate announced by the National Bank of Poland for the day preceding the transaction (if other regulations regarding means coming from the EU budget or from other countries of the EEA do not state otherwise).

The IAS 21 offers greater flexibility in the case of choosing the exchange rate. It is important to note that the average exchange rate can only be used if it is not subject to great variations. Furthermore, the rules regarding the translation of liabilities and assets are different than those set forth in the Accounting Act.

International regulations introduce the division into monetary items, non-monetary items carried at historical cost and non-monetary items carried at fair value. Foreign currency monetary amounts should be reported using the closing rate. Yet, there are no exchange differences on non-monetary items carried at historical cost, because the same exchange rate is used on the day of the transaction and the balance sheet day. Non-monetary items carried at fair value should be reported at the rate that existed when the fair values were determined, therefore exchange differences may appear (JARUGA 2004, p. 171).

Another element that causes differences between financial statements prepared according to the International Financial Reporting Standards and financial statements subject to the Polish Accounting Act is the definition of monetary items in the standard which "are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency" (IAS 21.8). In the view of the Accounting Act, long term investments can be treated as monetary amounts. Exchange differences resulting from transactions on long terms investments are recognized directly in equity (GABRUSEWICZ, SAMELAK 2006, p. 58), the IAS requires the exchange differences to be reported in profit or loss in the period.

In the case of exchange differences regarding investment property carried at fair value according to the IAS 40 the entity reports the changes of fair value in costs and losses of the given period. The Accounting Act however requires the exchange differences to be recognized in equity (JARUGA 2004, p. 174).

Recognition of exchange differences in assets is another issue. According to the Accounting Act, art 28(4), the entity, in circumstances justified by necessary, long-term preparation of goods for resale or a finished product for sale or by the long-term manufacture of a finished product, the cost of acquisition or manufacture may be increased by the cost of servicing liabilities incurred to finance the inventories of goods for resale or finished products over the period of their preparation for sale or manufacturing and by related foreign exchange differences, less related revenue. The International Accounting Standards advise that only a reasonable part of the exchange differences can be recognized into the value of property, plant or equipment under construction, intangible assets, goods for resale or finished products (IAS 23.12). This means that a part of the exchange differences may not be included in the financial result of the given period.

Another difference between Polish and international regulations is the fact that IAS 21 uses simplified methods of translation of financial statements of entities operating abroad. According to Polish regulations, an entity that has departments abroad which prepare their proper financial statements, prepares its financial statement in the following way:

– the balance sheet in foreign currency should be translated using the average exchange rate announced by the Bank of Poland for the balance day.

– profit and loss account statement should be translated using the exchange rate being an arithmetical mean of average exchange rates for every last day of financial months. In justified cases the exchange rate being an arithmetical mean of the balance sheet day and the former balance day average exchange rate can be used. (HELIN 2006, p.353).

Comparison of Polish regulations and the IAS for exchange differences

Table 1

Comparison of Polish regulations and the IAS for exchange differences

Accounting Act	IAS
1	2
Books of accounts shall be kept in the Polish language and currency (art. 9).	IAS 21 introduces a division into: – functional currency – the currency of the primary economic environment in which the entity operates and presentation currency – the currency in which the financial statements are presented (IAS 21.8).

cont. table 1

1	2
Foreign currency transactions shall be recorded on initial recognitions, (if other regulations regarding the means from the European Union's budget or from other countries from the European Economic Area, and non-refundable means from foreign sources do not state otherwise) by applying to the foreign currency amount the 1. the exchange rate that has actually been used, taking into account the character of the operation – sale or purchase of currency, payment of receivables or liabilities 2. the average exchange rate of the National Bank of Poland for the day preceding the day of the transaction, if using the exchange rate in point 1. is not justified (art. 30.2)	A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction (IAS 21.21).
1. Not rarer than for the balance sheet day: 1) assets in foreign currencies (not including the shares in subordinated business branches valuated at the equity method) and liabilities at the average exchange rate announced by the National Bank of Poland. 2) cash in the units dealing in foreign currency at the exchange rate that was used when the currency has been bought unless the exchange rate is higher than the exchange rate announced by the National Bank of Poland (art. 30.1)	At the end of each reporting period: (a) foreign currency monetary items shall be translated using the closing rate; (b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and (c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined (IAS 21.23).
Incomes and expenses resulting from exchange differences are recognized in the income statement with exception of – differences from revaluation of long-term investments which are recognized in supplementary or similar capital. – exchange differences resulting from liabilities financing elements of the assets, which are capitalized in the production cost or the cost of acquisition (art. 30.4).	
The cost of acquisition or manufacture of items of property, plant or equipment under construction, items of property, plant and equipment and intangible assets, is comprised of all the costs which an entity incurred for the period of construction, assembly, preparation and improvement, until the balance sheet date or the date of commissioning the assets for use, including also the costs of servicing liabilities incurred to finance them and related foreign exchange differences, less related revenue (art. 28.8.2). In justified situations, long preparation of products or goods or a long production process, the acquisition price or the cost of manufacture can	Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (IAS 23.6.e).

cont. table 1

1	2
be increased by the cost of servicing the liabilities incurred to finance the preparation process and the resulting exchange differences, less related revenue.	
All positions denominated in foreign currency in the financial statement of the foreign branch are translated into Polish currency at the average exchange rate announced by the National Bank of Poland for the day of gaining control of the foreign branch.	The assets and liabilities in foreign currency of the entity being taken over are to be translated by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction (IAS 21.21).
The financial statements of an entity having branches abroad (business units) which prepare their financial statements abroad, shall include relevant data of these branches denominated in foreign currency and translated into the Polish currency at the average exchange rate as at a given balance sheet date set for a given currency by the National Bank of Poland, whereas the profit and loss account data shall be translated at an exchange rate being an arithmetical mean of average exchange rates as at the last day of each month of the financial year and in justified cases at the average exchange rate being an arithmetical mean of average exchange rates as at the last day of the prior financial year and the last day of the current financial year (art 51.2).	The results and financial position of an entity for every following balance sheet day should be translated according to the following rules: – assets and liabilities for each statement of financial position presented (ie including comparatives) shall be translated at the closing rate at the date of that statement of financial position; – income and expenses for each statement of comprehensive income or separate income statement presented (ie including comparatives) shall be translated at exchange rates at the dates of the transactions however, an average exchange rate can be used. (IAS 21.39, 40).
The exchange differences that result from these transactions shall be presented in the aggregated financial statements as "currency translation differences" being a separate item of revaluation reserve in equity (art. 51.2).	All resulting exchange differences shall be recognized in other comprehensive income (IAS 21.39 c).
If shares in a co-subsidiary were disposed of during the financial year the exchange differences are recognized in the consolidated loss and profit account (art. 61.8).	On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognized in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognized (IAS 21.48).

Source: IAS 21, IAS 23, and HELIN, 2006, 26–70.

Conclusion

The establishment of ISAB and the creation of IFRS and IAS is of vital importance to business entities as it allows for a greater transparency of financial statements prepared in different countries.

It is important to note the fact that international regulations are more flexible than the Polish ones. This simplifies the process of preparing financial statements, as it allows the business entities to use the most efficient methods of calculating the exchange differences so that the financial statement may represent the actual situation of the company in the best possible way.

However, the lack of explicit directives creates a gap for some deliberate and non-deliberate misinterpretations. It could even mean that different financial statements (correct in the view of the IAS) may be prepared for the same business entity depending on the assumptions used. The determination of the extent of this problem would demand a research of a greater scope.

It can be clearly stated that the discrepancies between the international standards and the Polish Accounting Act, in the case of exchange differences, are significant because the IAS is using a different approach which focuses on issues like the presentation and functional currency and the division into monetary and non-monetary items. The Accounting Act mainly concentrates on the types of exchange rates to be used during the translations. Again this means that financial statements prepared according to the Accounting Act and the IAS may differ in the case of exchange differences.

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