DIGITAL CFO SOLUTIONS • IFRS SERIES

ACTIVE STANDARD

INTERNATIONAL FINANCIAL REPORTING STANDARDS

IAS 21

Effects of Changes in Foreign Exchange Rates

Functional currency, foreign currency transactions, and translating foreign operations — updated for the 2025 lack-of-exchangeability amendment and IFRS 18

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ROADMAP

What We Will Cover

Foundations & Scope

Key definitions, and what falls outside IAS 21 entirely

Functional Currency

The indicators that determine an entity's functional currency, and when it changes

Foreign Currency Transactions

Initial recognition, subsequent measurement, and exchange differences

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PART I — FOUNDATIONS

The Effects of Changes in Foreign Exchange Rates

IAS 21 prescribes how to include foreign currency transactions and foreign operations in an entity's financial statements, and how to translate financial statements into a presentation currency.

Key Definitions

- Functional currency: the currency of the primary economic environment in which the entity operates.
- Presentation currency: the currency in which the financial statements are presented.
- Foreign currency: a currency other than the functional currency of the entity.
- Foreign operation: an entity that is a subsidiary, associate, joint arrangement or branch of the reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.
- Monetary items: units of currency held, and assets and liabilities to be received or paid, in a fixed or determinable number of units of currency.
- Exchange difference: the difference from translating a given number of units of one currency into another currency at different exchange rates.
- Net investment in a foreign operation: the amount of the reporting entity's interest in the net assets of that operation.
- Closing rate / spot exchange rate: the exchange rate for immediate delivery, used to translate items at the reporting date.

Scope — What IAS 21 Excludes

IAS 21 applies broadly to foreign currency transactions and foreign operations, but explicitly carves out two areas covered by other Standards.

Hedge Accounting (IFRS 9)

IAS 21 does not apply to hedge accounting for foreign currency items, including the hedge of a net investment in a foreign operation — these are addressed under IFRS 9.

Cash Flow Presentation (IAS 7)

The presentation, in the statement of cash flows, of cash flows arising from foreign currency transactions and the translation of cash flows of a foreign operation are addressed under IAS 7.

PART II — FUNCTIONAL CURRENCY

Determining Functional Currency

Every entity determines its own functional currency — the currency of the primary economic environment in which it operates — and measures its results and financial position in that currency.

Primary Indicators

An entity considers the following primary factors first in determining its functional currency.

Currency That Mainly Influences Sales Prices

The currency that mainly influences sales prices for goods and services — often the currency in which sales prices are denominated and settled.

Currency of the Competitive Environment

The currency of the country whose competitive forces and regulations mainly determine the sales prices of goods and services.

Currency That Mainly Influences Costs

The currency that mainly influences labour, material and other costs of providing goods or services.

Secondary Indicators & Change in Functional Currency

Secondary & Foreign-Operation Indicators

- The currency in which funds from financing activities (issuing debt and equity instruments) are generated.
- The currency in which receipts from operating activities are usually retained.
- For a foreign operation: whether its activities are an extension of the reporting entity, or carried out with significant autonomy.
- For a foreign operation: whether transactions with the reporting entity are a high or low proportion of its activities, and whether its cash flows directly affect, and are readily available for remittance to, the reporting entity.

Change in Functional Currency

- An entity's functional currency reflects the underlying transactions, events and conditions relevant to it, and is not changed unless there is a change in those underlying transactions, events and conditions.
- A change in functional currency is applied PROSPECTIVELY, from the date of the change.
- All items are translated into the new functional currency using the exchange rate at the date of the change.

When indicators are mixed, management uses judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions.

PART III — FOREIGN CURRENCY TRANSACTIONS

Foreign Currency Transactions

A foreign currency transaction is one denominated, or requiring settlement, in a currency other than the entity's functional currency.

Initial Recognition

A foreign currency transaction is recorded, on initial recognition, in the functional currency.

- The foreign currency amount is translated at the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.
- The date of a transaction is the date on which it first qualifies for recognition in accordance with IFRS Standards.
- For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used — e.g. an average weekly or monthly rate for all transactions in a foreign currency occurring during that period.
- Using an average rate is not appropriate if exchange rates fluctuate significantly during the period.

Subsequent Measurement at Each Reporting Date

1 Foreign currency monetary items

Translated using the closing rate at each reporting date.

2 Non-monetary items at historical cost

Translated using the exchange rate at the date of the transaction — not retranslated for subsequent changes in exchange rates.

3 Non-monetary items at fair value

Translated using the exchange rate at the date when the fair value was determined.

4 Income statement items

May be translated using an average rate for the period, as a practical approximation of transaction-date rates.

Recognition of Exchange Differences

Monetary Items

- Exchange differences arising on the settlement of monetary items, or on translating monetary items at rates different from those at initial recognition (or the previous reporting date), are recognised in profit or loss in the period in which they arise.
- An exception applies to a monetary item that forms part of a reporting entity's net investment in a foreign operation — see the next slide.

Non-Monetary Items

- When a gain or loss on a non-monetary item is recognised in other comprehensive income (e.g. a property revaluation), any exchange component of that gain or loss is also recognised in OCI.
- Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss is also recognised in profit or loss.

The exchange component simply follows the same statement as the underlying gain or loss it forms part of.

Net Investment in a Foreign Operation & Tax Effects

Certain intragroup monetary items receive special treatment because they are, in substance, part of the reporting entity's investment in a foreign operation.

- Exchange differences arising on a monetary item that forms part of an entity's net investment in a foreign operation are recognised in profit or loss in the SEPARATE financial statements of the reporting entity or of the foreign operation, as appropriate.
- In the financial statements that include the foreign operation and the reporting entity — i.e. consolidated financial statements — such exchange differences are recognised initially as a separate component of other comprehensive income, and reclassified from equity to profit or loss on disposal of the net investment.
- Tax effects of exchange differences: gains and losses on foreign currency transactions, and exchange differences on translating foreign operations, may have tax effects, which are accounted for by applying IAS 12 Income Taxes.

PART IV — FOREIGN OPERATIONS & TRANSLATION

Foreign Operations & Translation

Translating a foreign operation's results and financial position into the reporting entity's presentation currency, for inclusion by consolidation, proportionate consolidation or the equity method.

Translating a Foreign Operation for Consolidation

When translating a foreign operation for inclusion in the reporting entity's financial statements, three rules apply together.

Assets & Liabilities — Closing Rate

All assets and liabilities, including comparatives, are translated at the closing rate at the date of that statement of financial position.

Income & Expenses — Transaction-Date Rate

Income and expenses are translated at exchange rates at the dates of the transactions — an average rate for the period is a practical alternative, unless rates fluctuate significantly.

Resulting Differences — Equity

All resulting exchange differences are recognised as a separate component of other comprehensive income (the foreign currency translation reserve).

Goodwill, Fair Value Adjustments & Hyperinflation

Goodwill & Fair Value Adjustments

- Any goodwill arising on the acquisition of a foreign operation, and any fair value adjustments to the carrying amounts of assets and liabilities arising on that acquisition, are treated as assets and liabilities of the foreign operation.
- They are therefore expressed in the functional currency of the foreign operation, and translated at the CLOSING rate at each reporting date — not at the historical rate ruling at the acquisition date.

Hyperinflationary Foreign Operations

- The financial statements of a foreign operation whose functional currency is the currency of a hyperinflationary economy are first restated in accordance with IAS 29, before translation into the presentation currency.
- All amounts — assets, liabilities, equity, income and expenses, including comparatives — are then translated at the CLOSING rate at the date of the most recent statement of financial position.

Once an economy ceases to be hyperinflationary, an entity no longer restates financial statements under IAS 29 for the current or comparative periods.

PART V — DISPOSAL

Disposal of Foreign Operations

The cumulative exchange differences accumulated in equity in respect of a foreign operation are reclassified to profit or loss when that operation is disposed of.

Disposal & Partial Disposal

Full Disposal

- On disposal of a foreign operation, the CUMULATIVE amount of exchange differences relating to that foreign operation, recognised in OCI and accumulated in the separate component of equity, is reclassified from equity to profit or loss — as a reclassification adjustment — when the gain or loss on disposal is recognised.

Partial Disposal

- Partial disposal of a subsidiary that includes a foreign operation: the entity re-attributes the proportionate share of the cumulative exchange differences to non-controlling interests in that foreign operation — it is NOT reclassified to profit or loss.
- Any OTHER partial disposal of a foreign operation (e.g. of an associate or joint venture): the entity reclassifies to profit or loss only the proportionate share of the cumulative exchange differences.

See Illustration IV for a full worked example of recycling cumulative translation differences on disposal.

PART VI — DISCLOSURE

Disclosure Requirements

IAS 21 requires disclosures that let users assess an entity's exposure to, and the financial statement effects of, changes in foreign exchange rates.

DISCLOSURE

What the Notes Must Show

1 Exchange differences in profit or loss

The amount of exchange differences recognised in profit or loss, excluding those on financial instruments measured at fair value through profit or loss under IFRS 9.

2 Net exchange differences in OCI

Net exchange differences recognised in OCI and accumulated in a separate component of equity, with a reconciliation of the amount at the beginning and end of the period.

3 Presentation currency different from functional currency

When the presentation currency differs from the functional currency, that fact, the functional currency itself, and the reason for using a different presentation currency.

4 Change in functional currency

When there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change.

PART VII — APPLICATION

Worked Illustrations

Four worked examples covering a foreign currency purchase, determining functional currency, translating a foreign subsidiary, and disposal of a foreign operation.

WORKED ILLUSTRATIONS

Illustration I — Foreign Currency Transaction

FACT PATTERN

On 1 November 20X1, a US entity (functional currency USD) purchases inventory from a European supplier for €500,000, on 90-day credit. The spot rate on 1 November 20X1 is \$1.10/€1. At the entity's 31 December 20X1 year end, the closing rate is \$1.14/€1. The invoice is settled in full on 30 January 20X2, when the spot rate is \$1.16/€1.

SOLUTION

Initial recognition (1 November 20X1): the purchase and payable are recorded at the spot rate of \$1.10/€1 — inventory (or cost of sales) and accounts payable of \$550,000 (€500,000 × 1.10).

Year-end retranslation (31 December 20X1): the payable is a monetary item, retranslated at the closing rate of \$1.14/€1 = \$570,000. The \$20,000 increase is an exchange LOSS, recognised in profit or loss — the inventory itself, a non-monetary item at historical cost, is NOT retranslated.

Settlement (30 January 20X2): the payable is settled at the spot rate of \$1.16/€1 = \$580,000. The further \$10,000 increase is an additional exchange LOSS, recognised in profit or loss for the period of settlement.

Total exchange loss over the life of the payable is \$30,000 — split \$20,000 in 20X1 and \$10,000 in 20X2, matching the periods in which the rate moved.

Illustration II — Determining Functional Currency

FACT PATTERN

A UK-incorporated entity manufactures machinery in a factory in Germany. Raw materials and labour are paid for in euros. Nearly all output is sold to eurozone customers, with sales prices set and invoiced in euros, and euro sales receipts are retained locally to fund further eurozone operations. The entity's only borrowing was arranged in euros with a German bank. Required: determine the entity's functional currency.

SOLUTION

The primary indicators all point to the euro: sales prices are denominated and settled in euros, determined by eurozone competitive conditions; and labour and material costs are also denominated and settled in euros.

The secondary indicators reinforce this conclusion: financing was raised in euros, and operating receipts are retained and used in euros.

Even though the entity is incorporated in the UK, its functional currency is the EURO — place of incorporation and the currency used for legal or administrative filings are not functional currency indicators under IAS 21.

The entity measures its results and financial position in euros, then translates into GBP if GBP is chosen as the presentation currency, applying the closing-rate / average-rate method for a foreign operation.

WORKED ILLUSTRATIONS

Illustration III — Translating a Foreign Subsidiary

FACT PATTERN

A UK parent (presentation currency GBP) has a wholly-owned US subsidiary (functional currency USD). Opening net assets at 1 January 20X1 were $2,000,000 (opening rate $1.25/£1). Profit for the year was $300,000 (average rate $1.30/£1). No dividends were paid. Closing net assets are $2,300,000 (closing rate $1.35/£1). Required: the closing net assets in GBP, and the exchange difference for the year.

SOLUTION — closing rate / average rate method:

	USD ($)	Rate	GBP (£)
Opening net assets	2,000,000	1.25 (opening)	1,600,000
Profit for the year	300,000	1.30 (average)	230,769
Closing net assets (at mixed rates)	2,300,000	—	1,830,769
Closing net assets (retranslated)	**2,300,000**	**1.35 (closing)**	**1,703,704**
Exchange difference (loss) — to OCI	—	—	**(127,065)**

The retranslated closing net assets (£1,703,704) are lower than the closing net assets carried forward at mixed historical/average rates (£1,830,769) because the pound strengthened against the dollar during the year (the rate moved from $1.25/£1 to $1.35/£1). The resulting £127,065 exchange loss is recognised in OCI, as a movement on the foreign currency translation reserve — not in profit or loss.

Illustration IV — Disposal of a Foreign Operation

FACT PATTERN

A parent's cumulative foreign currency translation reserve relating to a wholly-owned foreign subsidiary stands at a debit (loss) balance of $450,000 at the date the subsidiary is sold in full to a third party for cash. The disposal gives rise to a gain on disposal, before considering the translation reserve, of $2,000,000, being sale proceeds less the subsidiary's net assets at the date of disposal. Required: show the accounting for the cumulative translation reserve on disposal.

SOLUTION

Because the ENTIRE foreign operation is disposed of, the full cumulative amount of exchange differences accumulated in the foreign currency translation reserve is reclassified from equity to profit or loss, as a reclassification adjustment, in the period of disposal.

The $450,000 cumulative translation loss is transferred out of OCI/equity and recognised in profit or loss, alongside the $2,000,000 gain on disposal of the net assets themselves.

Total gain recognised in profit or loss on disposal: $2,000,000 – $450,000 = $1,550,000.

Had this instead been a partial disposal of a subsidiary that retained control (e.g. selling 20% while keeping control), only the PROPORTIONATE share of the cumulative translation reserve relating to the interest disposed of would be re-attributed to non-controlling interests — not reclassified to profit or loss at all.

PART VIII — RECENT DEVELOPMENTS

Amendments & IFRS 18 Impact

The 2025 lack-of-exchangeability amendment, and how IFRS 18 reshapes the presentation of exchange differences.

Lack of Exchangeability (2023 Amendment)

Lack of Exchangeability (Amendments to IAS 21), issued August 2023 and effective for annual periods beginning on or after 1 January 2025, addresses a gap the original 1983-era Standard never contemplated.

- A currency is exchangeable into another currency when an entity is able to obtain the other currency within a normal administrative delay, through a market or exchange mechanism that creates enforceable rights and obligations.
- Where a currency is NOT exchangeable at the measurement date, an entity estimates the spot rate as the rate that would have applied to an orderly transaction between market participants at the measurement date, faithfully reflecting prevailing economic conditions.
- Acceptable estimation techniques include using an observable exchange rate without adjustment (if it meets the objective above), or an observable rate for a related currency pair, adjusted as necessary.
- New disclosures are required when a currency is not exchangeable: the nature and financial effects of the lack of exchangeability, the spot rate used, the estimation process, and the risks the entity faces because of it.

Impact of IFRS 18 on Exchange Difference Presentation

IFRS 18 Presentation and Disclosure in Financial Statements replaces IAS 1 and is effective for annual periods beginning on or after 1 January 2027 (early application permitted).

Operating Exchange Differences

Exchange differences on foreign currency transactions relating to an entity's main business activities (e.g. trade receivables and payables) are generally classified in the OPERATING category.

Financing-Related Differences

Exchange differences on foreign-currency-denominated borrowings and other financing items are generally classified in the FINANCING category, consistent with the item that gives rise to them.

What Does NOT Change

IFRS 18 does not alter how exchange differences are recognised or measured under IAS 21 — the impact is on which category of the income statement each component is presented in.

SUMMARY

Key Takeaways

Functional currency is a judgement call

Primary indicators — sales prices and costs — usually determine it; secondary and foreign-operation indicators resolve close calls.

Monetary items retranslate; non-monetary items don't

Monetary items use the closing rate at every reporting date; non-monetary items at historical cost stay at the transaction-date rate.

Exchange differences follow the underlying gain or loss

To profit or loss if the item’s gain/loss is in profit or loss; to OCI if the item’s gain/loss is in OCI.

Foreign operations translate at closing and average rates

Assets and liabilities at the closing rate, income and expenses at transaction-date (or average) rates, with differences to OCI.

Disposal recycles the translation reserve

Full disposal reclassifies the cumulative translation difference to profit or loss; partial disposal re-attributes or partially reclassifies it.

Exchangeability is now explicit

Since 2025, IAS 21 specifies how to assess exchangeability and estimate a spot rate when a currency isn't exchangeable.

ABOUT THE AUTHOR

A Career Built on Making IFRS Understandable

BD

B D Chatterjee

FCA · ACMA · ACS
DipIFR (ACCA – UK)

Published author of the Pocketbook of IFRS series

B D Chatterjee is a Chartered Accountant and financial thought leader with over 35 years of global experience spanning corporate finance, accounting standards, financial reporting, business valuation and financial due diligence. As a seasoned CFO, he has led finance functions across major corporations and now heads Digital CFO Solutions, a platform delivering institutional-grade IFRS, US GAAP and valuation workbooks alongside fractional CFO services.

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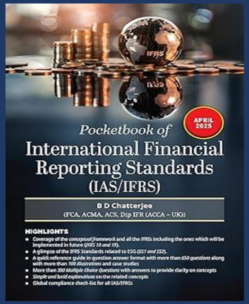
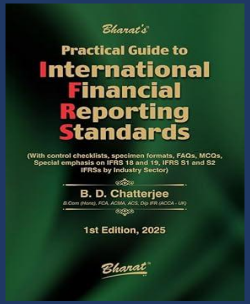
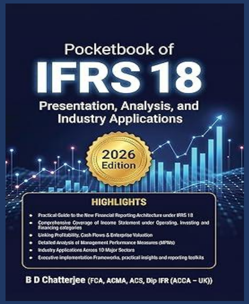


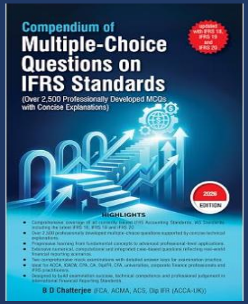
Pocketbook of International Financial Reporting Standards (IAS/IFRS)



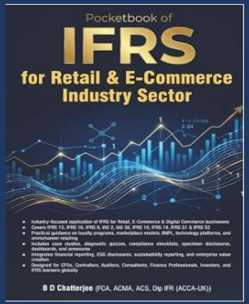
Practical Guide to International Financial Reporting Standards



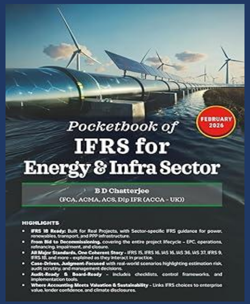
Pocketbook of IFRS 18 — Presentation, Analysis & Industry Applications



Compendium of Multiple-Choice Questions on IFRS Standards



Pocketbook of IFRS for Retail & E-Commerce Industry Sector



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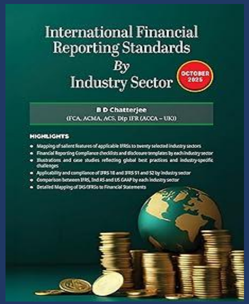

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