

FUNCTIONAL CURRENCY

VIEWPOINTS: Applying IFRSs in the Mining Industry

BACKGROUND

Given the global nature of their industry, mining entities often:

- enter directly into transactions that are denominated in foreign currencies; and
- conduct foreign operations through a subsidiary, an equity interest, a joint venture or a directly owned operation.

IAS 21, *The Effects of Changes in Foreign Exchange Rates*, provides guidance to include these foreign currency transactions and foreign operations in the financial statements of an entity. In preparing financial statements, each entity – whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) – is required by IAS 21 to:

- determine its functional currency; and
- translate foreign currency items into its functional currency and report the effects of such translation.

The functional currency is defined as the currency of the primary economic environment in which the entity operates. The functional currency was previously referred to as the *measurement currency* under pre-changeover accounting standards. A foreign currency is defined as a currency other than the functional currency of the entity.

It is important to note that there is no “group” functional currency for group financial statements. Each entity included within the group financial statements should undertake its own determination of functional currency. Furthermore, an entity’s functional currency may differ from its presentation currency, which is defined as the currency in which the financial statements are presented. The presentation currency was previously referred to as the *reporting currency* under pre-changeover accounting standards. This publication addresses issues related to functional currency, not presentation currency.

An entity’s functional currency can have a substantial effect on its results and financial position because IAS 21 requires all

Mining Industry Task Force on IFRSs

Canada’s move to International Financial Reporting Standards (IFRSs) creates unique challenges for junior mining companies. Financial reporting in the sector is atypical due to significant differences in characteristics between junior mining companies and other types of companies. The Canadian Institute of Chartered Accountants (CICA) and the Prospectors and Developers Association of Canada (PDAC) created the Mining Industry Task Force on IFRSs to share views on IFRS application issues of relevance to junior mining companies. The task force’s views are provided in a series of papers that are available through free download. These views are of particular interest to chief financial officers, controllers and auditors.

The views expressed in this series are non-authoritative and have not been formally endorsed by the CICA, PDAC or the organizations represented by the task force members.

foreign currency amounts (e.g., foreign currency assets, liabilities, revenues and expenses) to be translated into the functional currency. In addition, many Canadian holding companies in the mining industry may determine that their functional currency is the U.S. dollar (USD) and may, therefore, need to classify warrants issued with an exercise price denominated in Canadian dollars (CAD) as derivative liabilities (measured at their fair value with changes in fair value included in profit or loss).

The determination of an entity's functional currency is a matter of judgment based on an assessment of the specific facts and circumstances relevant to each entity. A Canadian mining entity may reach a different conclusion with respect to functional currency under IFRSs than it had previously because the approach to determine the functional currency under IAS 21 is fundamentally different from that under pre-changeover accounting standards, Section 1651, *Foreign Currency Translation*.

ISSUE

How does an entity determine its functional currency?

VIEWPOINTS

Determining Functional Currency

IAS 21 provides primary indicators and secondary indicators to consider in determining the functional currency; it requires management to give priority to the primary indicators before considering the secondary indicators, which are designed to provide additional supporting evidence to determine an entity's functional currency.

When the indicators are mixed and the functional currency is not obvious, IAS 21 requires management to use its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Primary Indicators

The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity is required by IAS 21 to consider the following factors in determining its functional currency:

- (a) the currency:
 - (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and
 - (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
- (b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

In the mining industry, sales prices for metals are often denominated and settled in USD; however, the USD may only be acting as a currency of convenience (i.e., it may not in fact influence sales prices) and, as a result, sales prices may fluctuate in response to changes in the USD exchange rate.

For example, a Canadian mining entity may sell its production of gold to the Royal Canadian Mint in USD. Although the USD is often the currency in which sales prices for gold are denominated and settled, this does not necessarily mean that the USD is the currency that mainly influences sales prices for gold because the sales prices for gold are determined in global markets.

For many of the commodities sold by mining entities, it will be difficult to identify a single country whose competitive forces and regulations mainly determine the sales prices because of the global nature of the mining industry.

The currency that mainly influences costs of a mining entity will often be a currency other than the currency of the local environment. For example, a foreign operation in Zimbabwe may determine that it is the USD that mainly influences costs because it imports significant inputs (e.g., labour and equipment) from the United States and, as a result, incurs a significant amount of its costs in USD.

Secondary Indicators

The following factors in IAS 21 may also provide evidence of an entity's functional currency:

- (a) the currency in which funds from financing activities (i.e., issuing debt and equity instruments) are generated.
- (b) the currency in which receipts from operating activities are usually retained.

In determining the functional currency of a foreign operation and whether its functional currency is the same as that of the reporting entity (the reporting entity, in this context, being the entity that has the foreign operation as its subsidiary, branch, associate or joint venture), the following additional factors in IAS 21 are considered:

- (a) whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy.
- (b) whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.
- (c) whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.
- (d) whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

Holding Companies

A typical Canadian holding company in the mining industry holds foreign subsidiaries but has no (or minimal) operating activities of its own.

The functional currency of such a company is determined in the same way as that of any other type of entity. IAS 21 provides primary indicators and secondary indicators to consider in determining the functional currency and requires management to use its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Mining Entities Not Yet Generating Revenues

Once an entity's functional currency is determined, IAS 21 allows it to be changed only if there is a change in the underlying transactions, events and conditions that are relevant to the entity; therefore, a mining entity may need to reassess its functional currency when it begins to generate revenues.

The Mining Industry Task Force on IFRSs

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For more information on IFRSs visit:

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