Let's Talk About IFRS

Coffee Chat

Brewing Over

Foreign denominated revenue transactions

IAS 21 *The Effects of Changes in Foreign Exchange Rates* (IAS 21) provides us with guidance relevant to translate transactions, balances and foreign operations into a preparer's functional currency – the currency of the primary economic environment in which the entity operates.

IAS 21 however, is to be applied almost as an overlay once the relevant IFRS standards have been applied in determining the appropriate recognition and measurement treatment of the relevant transactions and or balances.

Therefore, in a revenue transaction, which may be denominated in a currency other than the entity's functional currency, the revenue recognition principles of IFRS 15 *Revenue from Contracts with Customers* (IFRS 15) are to be applied first. Once the transactions and balances (if applicable) have been determined in accordance with IFRS 15, IAS 21 principles are then applied to those transactions and balances respectively.

This may seem relatively straight forward. However, let me propose a scenario which may alter your perception.

Lets assume X enters into a contract with Y on 1 January 2020 (exchange rate ZAR10 = \$1). Terms of the contract are that Y is required to pay 50% of the contract price at the date of signing the contract. This amount is non-refundable. The remainder of the price is payable at delivery of the product, expected to be in 12 months. In accordance with IFRS 15, the transaction price is calculated at \$1,5 million and revenue is recognised at a point in time, at delivery. The functional currency of X is the ZAR, and their year end is 31 December (exchange rate ZAR12 = \$1). Assume delivery and revenue recognition takes place on 31 December 2020.

Based on the fact pattern, we know \$750,000 (&1.5 million x 50%) is paid on 1 January 2020, and the exchange rate is ZAR10 = \$1, therefore X processes the following journal:

Cr Contract Liability 7 500 000

(A contract liability in terms of IFRS 15 represents the outstanding obligation to perform.)

At 31 December 2020, the product is delivered and revenue can be recognised in accordance with IFRS 15.

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IAS 21 requires transactions to be recorded at their spot rate – being the exchange rate on the date of the transaction.

As revenue is recognised at 31 December, some preparers may assume revenue to be recognised in ZAR on that date, calculated by translating the transaction price ($1,5 million) at the spot exchange rate on 31 December (ZAR12 = $1) to be:

Cr Revenue	18 000 000

However, a contract liability of R7 500 000 has already been recognised - which would be released to revenue in accordance with IFRS 15. In addition, the remainder of the price ($750 000) was received on 31 December, representing a cash inflow of R9 000 000. This however amounts to R16 500 000.

If revenue recognised should be R18 000 000, where does the difference of R1 500 000 (R18 million less R16,5 million) get recorded? Should it be a foreign exchange gain or loss in profit or loss?

This proposed treatment however illustrates the misapplication of IAS 21.

IFRIC 22 *Foreign Currency Transactions and Advance Consideration* (IFRIC 22) states the date of the transaction for the purposes of determining the exchange rate on initial recognition *is the date on which an entity initially recognises the non-monetary*[1] *asset or non-monetary liability arising from the payment or receipt of advance consideration.*

Therefore, the date on which the advance payment is received, is itself a transaction date. The advance payment represents a non-monetary item, and is translated into ZAR at the spot rate on the date the cash payment is received.

As the contract liability represents the amount already received (and banked) by X, it is no longer exposed to subsequent exchange rate fluctuations, therefore there is no retranslation of this amount, and no foreign exchange gain or loss recognised on this amount when the contract liability is recognised as revenue.

By applying IFRIC 22 and IAS 21 the following journal illustrates the appropriate journal to be processed on 31 December 2020:

Dr Contract Liability	7 500 000	
Dr Bank	9 000 000	
Cr Revenue		16 500 000

The amount recognised as revenue is a combination of the amount received upfront as the advance payment and the amount received on 31 December 2020. You will note there is no foreign exchange gain or loss recognised.

It is interesting how often this question arises in practice. Therefore to the extent you, or perhaps your clients, are transacting in foreign currencies – keep a look out for these types of transactions, and ensure the correct application of the standards.

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