Chapter 12

Important Managerial Controversies in Conversion of Financial Statements

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ABSTRACT

Functional currency has been defined as the currency of an entity’s main economic environment. A group does not have a functional currency, but the functional currency is set at the level of each group entity. Determining each functional currency at each component of a group is made by looking at several factors. In this chapter, the conversion occurs when the currency in which the financial statements are prepared is different from the presentation, and the important managerial controversies are presented in the conversion of the financial statements. The results show that the conversion of financial statements applies only if the entity whose financial statements are converted has a functional currency that is not a hyperinflationary economy.

INTRODUCTION

The International Accounting Standard (IAS) shall be taken into account when accounting for transactions denominated in foreign currency or when the financial statements are translated into the presentation currency (Ball, Li & Shivakumar, 2015; Iatridis, 2010; Guthrie & Parker, 2016). The conversion occurs when the currency in which the financial statements are prepared is different from the presentation cur-

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With respect to the conversion of financial statements, it should be noted that this standard applies only if the entity whose financial statements are converted has a functional currency that is not a hyperinflationary economy (Jones & Smith, 2012; Watts & Zimmerman, 1978; Richardson, 2011; Ball, Li & Shivakumar, 2015).

In examining whether significant influence does exist, we will take into account the existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities (Choi, Peasnell & Toniato, 2013; Barth, Landsman & Lang, 2008; Cairns, D., Massoudi, Taplin & Tarca, 2011). Potential voting rights that are currently exercisable or convertible must be taken into account because an entity may own warrants on shares, options to purchase equities, debt or equity securities that are convertible into ordinary shares or other financial instruments - if exercised or converted - and that can lead: either providing an entity that holds more voting rights; or reduce the voting rights of another party’s financial and operating policies (i.e. potential voting rights).

It is considered that potential voting rights are not currently exercisable or convertible if they cannot be exercised or converted until a future date or until the occurrence of a future event. If the investor loses the power to participate in decision-making regarding financial and operating policies of the investee entity, then we can say that it has lost significant influence (Allen & Ramanna, 2013; Bozec, 2008; Chen, Tang, Jiang & Lin, 2010; Tendeloo & Vansrelen, 2005).

A joint venture type of shared commitment where the parties have joint control of the undertaking and also of the rights to the net assets of the undertaking (Daske & Gebhardt, 2006; Marra, Mazzola & Prencipe, 2011). There may be joint commitments which the parties have rights to the assets and obligations for liabilities related to commitment (Ghosh & Olsen, 2008; Landsman, Maydew, & Thornock, 2012). This type of commitment is called joint venture operation and it is not covered by this material, nor do we apply the equity method (Pope & McLeay, 2011; Pieper, Trevor, Weller & Duchon, 2017).

If the overseas operation acts as an extension of the reporting entity (the entity that has the foreign operation as a subsidiary, branch, associate or joint commitment) then its functional currency is the same as the reporting entity (Schleicher, Tahoun & Walker, 2010). The Standard specifies that an entity’s functional currency reflects the transactions, events and underlying conditions that are relevant to it (Xiong, 2006; Leuz, Nanda & Wysocki, 2003). Consequently, once determined, the functional currency changes only if there is a change in those transactions, events and underlying conditions.

Foreign currency transactions are those transactions that are denominated in foreign currency (Zeghal, Chtourou & Fourati, 2012; Dechow, Sloan & Sweeney, 1996). They include, in accordance with IAS 21, the resulting transactions: when an entity buys or sells goods or services the price of which is denominated in foreign currency; borrows or lends funds when the due amounts are denominated in foreign currency; or otherwise acquires or disables assets, supports or repays debts denominated in foreign currency.

A foreign currency transaction - once the functional currency is established - may be recorded in the functional currency according to the two moments, initial recognition and subsequent recognition, as follows: initial recognition - the foreign currency exchange rate of the functional currency and the foreign currency, at the time of the transaction; the subsequent recognition (at the end of each reporting period) - the items will be converted according to their nature, monetary or non-monetary items (Ahmed, Neel & Wang, 2013; Thong, Ding & Lim, 2008; DeFond, 2010).

The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture established by using the equity method, and any long-term interests that, in fact, part of entity’s net investment in the associate or joint venture (Barth, 2013; Kothari, Leone & Wasley,