

## **Practical Guidance No. 4 (Issued – March 2010)**

### **Topic: Auditor's Assessment of Functional Currency for a Standalone Singapore Incorporated Company**

#### **Introduction**

1. In today's business environment, it is not unusual for entities to expand their customer base to overseas markets or to have their operations extended overseas to countries where the costs of or incentives for doing businesses are more attractive. It is also common for entities to source for the best vendor in terms of quality and pricing and this may entail purchasing from overseas vendors. Inevitably, such cross border business transactions would increasingly require entities to trade in a variety of currencies and not limit them to only Singapore dollar ("S\$") transactions. This often clouds the determination of the functional currency of an entity and poses a practical problem for the management in their assessment of the appropriateness of functional currency. This in turn creates an issue for the auditors when they review management's functional currency assessment.
2. This Practice Guidance aims to provide some practical considerations to auditors in their review of the management's assessment of the appropriate functional currency of a standalone Singapore incorporated company, i.e. not a foreign operation of another reporting entity based out of Singapore.

#### **Guiding Principle**

3. Financial Reporting Standard ("FRS") 21 "The Effects of Changes in Foreign Exchange Rates" defines functional currency as the currency of the primary economic environment in which the entity operates. The primary economic environment is normally the economy in which the entity primarily generates and expends cash (paragraphs 8 and 9).
4. FRS 21 also states that the primary indicators of determining an entity's functional currency are (paragraph 9):
  - A. The currency 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);
  - B. The currency of the country whose competitive forces and regulations mainly determine the sale prices of its goods and services; and
  - C. 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).
5. The secondary indicators designed to provide additional supporting evidence in the determination of an entity's functional currency are (paragraph 10):

- A. The currency in which funds from financing activities are generated; and
  - B. The currency in which receipts from operating activities are usually retained.
6. An entity has to take into consideration the abovementioned primary and secondary indicators in the assessment of its functional currency which should most faithfully represent the economic effects of the underlying transactions, events and conditions relevant to it. If the indicators are mixed and do not give a clear indication of the appropriate functional currency, the Standard states that priority is to be given to the primary indicators in FRS 21.9 before the secondary indicators are considered (paragraph 12).

### **Practical Application**

7. Primarily, the auditor will have to obtain and review management's assessment of the functional currency to determine if the assessment is reasonable and has been performed in accordance with the factors stated in FRS 21.

### ***Primary economic environment***

8. FRS 21.9 has stated that the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. For the assessment of the functional currency, an entity should not base its conclusion solely on the above statement but to consider the various factors and provisions as listed in FRS 21.9 to FRS 21.14.
9. As an illustration, consider the scenario where a Singapore standalone company transacts (ie both sales and purchases) with companies in Singapore, but the transactions are denominated and billed in United States dollar ("US\$"). In this scenario, the functional currency should not be assumed to be S\$ just because the company is doing business in Singapore – being the "primary economic environment in which it generates and expends cash but US\$ given that this is the currency that mainly influences sales prices for goods and services and in which sales prices for its goods and services are denominated and settled.

### ***Single dominant currency that influences sales prices for goods and services***

10. Consider the following scenario: A Singapore standalone company has overseas customers and local suppliers. Its sales and purchases are denominated in US\$ and S\$ respectively. The operating expenses (including staff costs) are also in S\$. This could apply to a company whose main customers are in countries such as Vietnam or Indonesia where US\$ is one of the predominantly used currency in the country.

If the management assesses that the functional currency of the company is S\$ simply because the company is incorporated and domiciled in Singapore and operating expenses

are denominated in S\$, this is not considered as an appropriate assessment in accordance with the principle in FRS 21. The auditor would need to go back to the management to revise the assessment accordingly by considering the primary indicators first, followed by the secondary indicators as stated in FRS 21.

11. On the other hand, if the management assesses that the functional currency is S\$ because the sales prices are determined based on a S\$ cost structure of the goods or services provided and management makes pricing decisions with the impact of S\$ in mind (per FRS 21.9a) and billings done in foreign currencies are merely for the convenience to the customers, the auditor will need to obtain corroborative audit evidence to support the management's assessment. For example, the auditor could request for the costing information or budgets of the company to determine if they have been prepared based on S\$. In addition, he could also review the minutes of management meetings to determine if management's discussion on issues relating to sales are carried out with S\$ in mind.
12. In the next scenario, a company is engaged in the trading of crude oil and it has both local and overseas customers while its suppliers are mainly from overseas. Both its sales and purchases are denominated in US\$ with operating expenses denominated in S\$.

Similarly, the auditor may not consider the assessment performed by management to be appropriate if the functional currency of the company is assessed to be S\$ merely on the basis that the company and its management are in Singapore and its financing and operating expenses are in S\$. As oil price is subject to the worldwide supply and demand, and crude oil is globally traded in US\$, the revenue analysis points to US\$ and the auditor would need to discuss with management on the need to revise the assessment of the appropriate functional currency using the primary indicators listed in FRS 21.9.

***Mixed bucket of foreign currencies that influence sales prices for goods and services***

13. In situations where there is no single dominant currency that influences the sales price, the currency that influences the costs of providing the related goods or services will need to be considered. These will include the purchase costs, material costs, labour costs, etc. Likewise, in the review of management's assessment, the auditor will need to exercise his professional judgement and gather corroborative audit evidence to verify the appropriateness of management's assessment of the functional currency.

14. Consider the following scenario: A company has both local and overseas customers and has sales denominated in US\$ (30%), Euro (40%) and S\$ (30%). Its purchases are mainly denominated in S\$ and all the operating expenses (including staff costs) are similarly denominated in S\$. As purchases and operating expenses are mainly in S\$, the company retains most of its receipts from its operations in S\$ as part of its working capital.

If management had determined the functional currency to be S\$ for this scenario on the basis that purchases and operating expenses are mainly in S\$ (per FRS 21.9b) as well as the retention of its receipts in S\$, the auditor should verify and corroborate management's representation such as to request for a breakdown of the purchases in the different source currencies to ascertain if majority of the purchases are indeed denominated in S\$. The auditor could also peruse the ledger accounts for expenses and the different bank accounts kept by the company to assess if these are also in S\$.

### **Conclusion**

15. The auditors need to bear in mind that notwithstanding that the responsibility in determining the functional currency lies with the management, it is also the auditors' responsibility to review critically and ensure that the assessment made by the management is appropriate and in accordance with the guiding principle of FRS 21.

16. In situations where indicators are mixed, the auditors are required to exercise their professional judgment and skepticism to determine if management's assessment is reasonable.

### **Disclaimer Statement**

1. This publication contains general information only and the Institute of Certified Public Accountants of Singapore (ICPAS) is not, by means of this document, rendering any professional advice or services. This document is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a professional advisor.

2. Whilst every care has been taken in compiling this publication, ICPAS makes no representations or warranty (expressed or implied) about the accuracy, suitability, reliability or completeness of the information for any purpose.

3. ICPAS, its employees or agents accept no liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly from any actions or decision taken (or not taken) as a result of any person relying on or otherwise using this publication or arising from any omission from it.