Lack of Exchangeability - Towards Exposure Draft
Cover Note

Objective

1 The objective of the session is to:

(a) inform or update EFRAG CFSS and TEG members on the IASB's project to amend IAS 21 *The Effect of Changes in Foreign Exchange Rates* in order to respond to the issues raising on lack of exchangeability of a functional currency; and

(b) collect your views on the tentative decisions of the IASB, that will be basis of forthcoming Exposure Draft (the ED), as the topic is in the ASAF agenda for December 2020 meeting.

2 This paper provides a history of the IASB's project together with an explanation of the issue and the IASB's proposals.

3 This paper is based on the public Agenda Papers of the IASB and on other IASB publication e.g. IFRS Update.

The issue – lack of exchangeability

4 IAS 21 provides the requirements on translating financial statements from functional currency into presentation currency. The requirements also cover translating the financial statements of a foreign operation (subsidiary) by the reporting entity (parent) for the consolidation purposes.

5 However, IAS 21 does not provide any specific requirements on what exchange rate a reporting entity uses to translate the results and financial position of a foreign operation when there is a longer-term lack of exchangeability between the functional currency of the foreign subsidiary (operation) and the presentation currency of the reporting entity. In other words, IAS 21 lacks requirements on the exchange rate an entity uses when the spot exchange rate (as defined in IAS 21) is not observable.

6 Moreover, for hyperinflationary economies (which may also be accompanied by lack of exchangeability as well as it may be a separate issue), IAS 29 *Financial Reporting in Hyperinflationary Economies* requires the reporting entity to firstly restate non-monetary assets and liabilities of the foreign subsidiary to reflect inflation by applying *a general price index* before retranslating subsidiary's financial statement into reporting currency.

7 In Venezuelan jurisdiction, with the local currency Venezuelan Bolivar (VEF), it was reported that:

(a) entities have been unable for several years to exchange VEF to other currencies needed to repatriate dividends or make investment-related payments;

(b) the official VEF exchange rates were not free-floating rates;

(c) the lack of exchangeability of VEF with other currencies has increased the disconnect between the official exchange rates of that currency and the inflation rate in Venezuela.

8 Consequently, the use of the official exchange rates to translate the financial statements resulted in overstating the relative share of those foreign operations in the total assets, liabilities, equity, income and expense of the reporting group. For instance, it resulted in overstating the value of the subsidiary's cash and cash equivalents in group financial position, without the actual possibility of exchanging that cash and cash equivalents into foreign currency for the purposes of paying the dividends.

9 Furthermore, the application of IAS 29 has exacerbated the distortions described above. Namely, in accordance with IAS 29, non-monetary assets and liabilities of the Venezuelan foreign operations (denominated in VEF) need to be restated to reflect hyperinflation by applying a general price index. However, the official exchange rates of VEF are not free-floating, and do not reflect the inflation rate prevailing in Venezuela. That disconnect between the inflation rate and the official exchange rates results in overstating the reported non-monetary assets and liabilities. Moreover, this overstatement increases over time.

10 This disconnect also affects the reported gain or loss on translation of subsidiary's net monetary position results (denominated in VEF), the amounts included in the statement of comprehensive income, and generally all individual line items in the statement of profit or loss.

11 Furthermore, as a result of lack of guidance on what exchange rate a reporting entity should use in such situation, a diversity in reporting practices has arisen with respect to Venezuelan operations. Three main reporting practices has been identified:

(a) the use of one of the official exchange rates;

(b) the use of an estimated exchange rate, adjusted to reflect inflation in Venezuela; and

(c) the deconsolidation of Venezuelan foreign operations.

History of the project - background

12 In 2014, following a submission, the IFRS Interpretations Committee (the IFRS IC) considered the issue, described above. In November 2014, the IFRS IC concluded that the matter of which exchange rate to use when there is a longer-term lack of exchangeability of a currency is too broad in scope for the IFRS IC to address. Consequently, the IFRS IC decided not to add the matter to its technical agenda.

13 In its Agenda Decision, however, the IFRS IC noted that several disclosure requirements would apply when the effect of foreign exchange controls is material to understanding an entity's financial performance and position.

14 Following that agenda decision, the IASB stakeholders have informed the IASB Staff that subsequent developments in Venezuela increased the severity of the matter and that the official exchange rate of the Venezuelan Bolivar does not faithfully represent the economic.

15 Consequently, the IFRS IC re-opened their discussion and, in June 2019, decided to recommend that the IASB propose a narrow scope amendment to IAS 21 which would address the issue. In November 2019, the IASB agreed with the recommendation of the IFRS IC and, tentatively, decided to undertake narrow-scope standard-setting.

16 In April 2020, the IASB tentatively decided to amend IAS 21 and, in July 2020, the IASB decided to publish an exposure draft (ED) and clarified that the proposed amendments would:

(a) define exchangeability and thus a lack of exchangeability,

(b) specify how an entity determines the spot exchange rate when a currency lacks exchangeability, and

(c) require further disclosures.

17 The details of the tentative IASB decisions together with the proposed transition requirements, are provided in the section below.

18 The IASB also decided also that the ED will be published with a 120-day comment period. The ED is expected in Q1 2021.

Amendments proposed by the IASB

19 At its April 2020 meeting, the IASB tentatively decided to propose the following amendments to the IAS 21 requirements in order to address how an entity should determine the spot exchange to use when exchangeability between two currencies is lacking.

Assessment of exchangeability and lack of exchangeability

20 The IASB tentatively decided that, when an entity assesses exchangeability, the entity be required to:

(a) consider whether it could obtain the foreign currency within a time frame that includes a normal administrative delay;

(b) consider its ability to obtain foreign currency, and not its intention (or decision) to do so;

(c) consider only markets or exchange mechanisms that create enforceable rights and obligations;

(d) assume that the purpose of obtaining foreign currency is to:

(i) settle individual foreign currency transactions, or assets or liabilities related to those transactions, when it reports foreign currency transactions in the functional currency; or

(ii) realise the entity's net assets when it uses a presentation currency other than the functional currency (or to realise its net investment in a foreign operation when it translates the results and financial position of that foreign operation).

(e) conclude that a currency lacks exchangeability in circumstances in which it is able to obtain only some amounts of foreign currency, when, for a particular purpose, it is able to obtain no more than an insignificant amount of foreign currency. Additionally, when an entity (i) reports foreign currency transactions in its functional currency, and (ii) can obtain less than the amount of foreign currency it needs to settle all balances and transactions in that currency, the entity would be required to assess exchangeability on an aggregated basis for all the related foreign currency balances and transactions.

The exchange rate when a currency lacks exchangeability

21 The IASB tentatively decided that:

(a) an entity should be required to estimate the spot rate when a currency lacks exchangeability;

(b) the objective for the estimation process would require an entity to estimate a spot rate that:

(i) the entity would have been able to access at the reporting date had the currency been exchangeable;

(ii) would have arisen in an orderly transaction between market participants; and

(iii) would faithfully reflect the economic conditions prevailing at that date.

(c) an entity would be permitted to use an observable rate (that does not meet the definition of a spot rate) if that rate approximates the spot rate in the following circumstances:

(i) when the observable rate meets the definition of a spot rate for particular transactions or balances but not those for which the entity assesses exchangeability; or

(ii) when the observable rate is the first subsequent rate at which exchanges could be made if exchangeability is restored before financial statements are authorised for issue.

(d) an entity would be required to apply an estimated exchange rate to:

(i) the entire transaction or balance of an asset or liability (when the entity reports foreign currency transactions in the functional currency); or

(ii) the financial statements as a whole (when the entity uses a presentation currency other than the functional currency).

22 A **flowchart** summarising the IASB tentative decisions (provided originally in Agenda Paper of April 2020 IASB meeting) is presented in **Appendix** of this paper.

Disclosure requirements when a currency lacks exchangeability

23 The IASB tentatively decided that an entity would be required to disclose:

(a) details of the currency that lacks exchangeability and a description of the restrictions that result in that lack of exchangeability;

(b) a description of the transactions affected by the lack of exchangeability;

(c) the carrying amount of assets and liabilities denominated in the currency that lacks exchangeability;

(d) the spot rate(s) used and whether that rate is:

(i) an observable rate that approximates the spot rate, or

(ii) one that has been estimated;

(e) a description of the estimation technique applied, and qualitative and quantitative information about the inputs used in that estimation technique; and

(f) qualitative information about each type of risk to which the entity is exposed because of a currency's lack of exchangeability, and the nature and carrying amount of assets and liabilities exposed to each type of risk.

24 Additionally, the IASB tentatively decided that, when a foreign operation's functional currency lacks exchangeability, an entity be required to disclose:

(a) the name of the foreign operation, its nature (whether it is a subsidiary, joint operation, joint venture, associate, or branch) and its principal place of business;

(b) summarised financial information about the foreign operation; and

(c) the nature and terms of any contractual arrangements that could require the entity to provide financial support to that foreign operation, including events or circumstances that could expose the reporting entity to a loss. The entity would also be required to disclose the balance of assets to which such arrangements give rise.

Transition requirements

25 In July 2020, the IASB tentatively decided that, if applicable, an entity would apply the amendment prospectively from the beginning of the annual reporting period in which it first applies the amendment (date of initial application) and not restate comparative information.

26 The IASB also tentatively decided to permit an entity to apply the proposed amendment earlier than the effective date.

EFRAG Secretariat initial analysis

27 The EFRAG Secretariat generally agrees with the IASB tentative decisions. In our view, the proposals would be fairly simple to apply and consistent with the existing principles in IAS 21. Consequently, we would expect that the resulting financial information would be relevant and useful for users of financial statements.

28 Regarding the proposed set of disclosures, we agree that disclosing the factors that led to the long-term lack of exchangeability as well as how an entity estimated the spot rate will provide useful information.

Questions for EFRAG CFSS and TEG members

29 Do you have comments on the IASB proposals to amend IAS 21?

30 How pervasive is this issue in your jurisdiction?

31 Do you expect that this amendment may be relevant to the groups/organisations in your jurisdiction? How this amendment may affect their financial reporting?

Agenda Papers

32 In addition to this cover note, *Agenda Paper 08-02 – ASAF Paper 04 – Lack of Exchangeability* – has been provided for the session for the background purposes.

Appendix: Determining the spot rate

33 The following chart summarises the IASB tentative decisions regarding how an entity should determine the spot exchange rate when a currency lacks exchangeability.