EFRAG
European Financial Reporting Advisory Group

EFRAG TEG meeting
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Paper 02-01
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EFRAG's Final Comment Letter on the IASB's Exposure Draft *Lack of Exchangeability*

Objective

1 On 20 April 2021, the IASB published Exposure Draft *Lack of Exchangeability* (the ED), with a 120-day comment period ending on 1 September 2021, where the IASB proposes to amend IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

2 On 3 June 2021, in its response to the ED, EFRAG published its Draft Comment letter on the ED (the DCL) with the deadline for comments on 26 August 2021**.**

3 The objective of the session is to:

(a) provide EFRAG TEG members a summary of the feedback received;

(b) discuss the EFRAG Secretariat proposal to finalise EFRAG's Comment Letter on the ED (the FCL);

(c) recommend EFRAG' Comment Letter to the EFRAG Board for approval. (The EFRAG Board will be asked to approve the FCL in a written procedure).

4 The background and the history of the project is provided in Appendix to this paper.

Feedback received from the outreaches

5 In the comment period, the EFRAG Secretariat held outreach activities to gain information on current practices applied in situations where a local currency lacks exchangeability.

6 The EFRAG Secretariat have received limited feedback from the EFRAG TEG Working Groups. The members that replied stated the following:

(a) one preparer expressed the view that guidance would be required to execute estimation of spot exchange rates especially using estimation techniques (like calculation models);

(b) users expressed the view that general disclosures and disclosures on input parameters for estimation techniques would be required to get a better understanding of the effects.

7 EFRAG Secretariat also consulted with some preparers and audit companies to get more information on the topic of lack of exchangeability and their view on the issue.

(a) Majority of audit companies broadly supported the proposals but pointed out that more guidance on measurement would be required. Some stated that, when estimating the exchange rate, an observable rate should be preferred to support comparability. One company had detailed comments on the ED about the notion of 'normal administrative delay', the application of the paragraphs

A13 of the ED, and more guidance on enforceable right and obligations etc. that are reflected in the recommendations.

(b) One preparer broadly supported the proposals, but also highlighted that more guidance on measurement (using estimation techniques) would be required.

8 The details of this feedback are provided in Agenda Paper 02.02 of this meeting.

Analysis of feedback received in comment letters

9 EFRAG Secretariat received six comment letter responses that broadly supported the approach taken by the IASB. Nevertheless,

(a) One respondent suggested not permitting an observable rate and rather requiring the use of it, whereas another respondent only stated that the IASB should further elaborate on the rationale for the approach taken;

(b) One respondent suggested providing more guidance on the use of estimation techniques and another respondent suggest something similar but specifically related to the use of unofficial exchange rate (black-market or parallel market rates).

10 The details of the analysis are provided in Agenda Paper 02.03 of this meeting.

EFRAG Secretariat`s recommendation

11 The following EFRAG Secretariat proposals regarding how to finalise EFRAG's FCL, based on the outreach feedback received from constituents, the comment letter responses, and from the EFRAG TEG meeting.

12 The appropriate changes have been done to the proposed EFRAG Comment Letter on the ED, which is available in Agenda Paper 02.04 of this meeting.

Question 1 - Assessment of whether a currency lacks exchangeability

13 Constituents, generally, supports the IASB`s proposals on how to assess whether two currencies are exchangeable or lack exchangeability.

14 The EFRAG Secretariat recommends retaining the original drafting of the DCL apart from the following points:

(a) EFRAG recommends reconsidering whether a restrictive application of the time period for a "normal administrative delay" in the light of Illustrative Example 4 (e.g., where it's stated as seven days) could inappropriately expand the application scope of the amendments, and whether not stating any number at all would be more appropriate. This is because the lack of exchangeability may be assessed in each jurisdiction in a different way and therefore in some jurisdiction an administrative delay of sixty days would be seen as "normal delay" while in others a delay more than seven days would be perceived as significant.

(b) EFRAG recommends refining the wording related to "exchangeability between currencies" as a lack of exchangeability is mostly only a one-way issue.

(c) EFRAG recommends considering more specific guidance on other legal currency exchange mechanisms (like Blue Chip Swaps in Argentina) and to consider whether their use would prevent a lack of exchangeability.

Question 2 - Estimating spot exchange rate

15 The EFRAG Secretariat is cognisant of participants' concerns that the use of estimated exchange rates may reduce comparability between entities and increase subjectivity. Therefore, the EFRAG Secretariat recommends the following changes in the drafting:

(a) EFRAG recommends to the IASB that the use of an observable exchange rate (as mentioned in paragraph A12 of the ED) should be preferred using a rebuttable presumption (with a high threshold), so that the use of an estimation technique would only be required under limited circumstances, when it is necessary to better reflect the economic reality.

(b) EFRAG supports the principles-based approach as laid out in the ED. In this regard EFRAG recommends to the IASB to add a measurement framework and further comprehensive guidance and examples on the estimation process without being too detailed. More guidance would assist preparers, ensure more comparability, improve consistency, and ease enforceability. The Framework should be aligned with IFRS 13 *Fair Value Measurement* to encourage the use of observable inputs.

(c) EFRAG further recommends to the IASB to consider more specific guidance on other legal currency exchange mechanisms (like Blue Chip Swaps in Argentina) and to consider whether those rates would constitute an observable exchange rate as considered in paragraph A12 of the ED.

Question 3 - Disclosure

16 The EFRAG Secretariat proposes that in the FCL the following requests should be made:

(a) to include disclosures on accumulated reserves for translation to the exchange rate in the consolidated financial statements would be useful (accumulated exchange differences since lack of exchangeability occurred); and

(b) to include disclosures on sensitivities related to important input factors used in the estimation technique regarding the effects on financial statements.

Question 4 - Transition

17 The EFRAG Secretariat proposes to retain the support for the proposed guidance and the original DCL drafting.

Questions for EFRAG TEG members

18 Do you have comments on the final EFRAG's Comment Letter proposed by the EFRAG Secretariat?

19 Do you recommend EFRAG's Comment Letter for the EFRAG Board to approve?

Agenda Papers

20 In addition to this issues paper, the following papers have been provided for the session:

(a) Agenda Paper 02.02 - Summary of the feedback received from EFRAG's outreaches;

(b) Agenda Paper 02.03 - Summary and Analysis of the Comment Letters received;

(c) Agenda Paper 02-04 - Proposed EFRAG's Final Comment Letter on the ED;

(d) Agenda Paper 02-04a - Summary and Analysis of the Comment Letters Received in markup;

(e) The ED is available on the IFRS Foundation web site on IFRS Foundation's website: https://www.ifrs.org/content/dam/ifrs/project/lack-of-exchangeability-amendments-to-ias-21/ed2021-4-lack-of-exchangeability-ias-21.pdf

Appendix – Project background

History of the project

21 IAS 21 provides the requirements regarding how to account for foreign currency transactions and operations in financial statements, and how to translate financial statements into a presentation currency.

22 An entity is required to determine a functional currency (for each of its operations if necessary) based on the primary economic environment in which it operates.

23 Currencies other than the functional currency of the reporting entity is defined as foreign currencies. Operations whit functional currency other than the functional currency of the reporting entity is defined as a foreign operation.

24 IAS 21 generally requires the use of spot exchange rates when an entity reports foreign currency transactions, the result and financial positions of a foreign operation in its financial statements or translates its financial statements to a currency that is not its functional currency.

25 IAS 21 specifies the exchange rate to use when exchangeability between two currencies is temporarily lacking.

26 However, IAS 21 does not provide any specific requirements on what exchange rate to use when a lack of exchangeability two currencies is not temporary.

27 The IASB has observed that those circumstances existed in Venezuela when the issue was taken to the IFRS Interpretations Committee in June 2018. In Venezuela, the jurisdictional authorities set a fixed official exchange rate that prevented the official exchange rate from being a free-floating rate. Furthermore, for several years, entities have been unable to exchange the currency to repatriate dividends or make investment-related payments.

28 The IASB has also observed that, in the past, diverse views on how to determine whether a currency is exchangeable into another currency, and which exchange rate to use when it is not, were developed by preparers. In the IASB`s view diversity in practice could lead to material differences in the financial statements of entities affected by a currency that lacks exchangeability.

29 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.

The guidance proposed by the IASB and its scope

30 On 20 April 2021, in order to respond to the issues related with exchangeability of a currency, the IASB proposed to amend IAS 21 and to specify:

(a) when a currency is exchangeable into another currency and, consequently, when it is not;

(b) how an entity determines the exchange rate to apply when a currency is not exchangeable; and

(c) the information an entity provides when a currency is not exchangeable.

31 EFRAG notes that the proposed guidance would apply to a wider range of situations where the local currency lacks exchangeability due to the economic or political environment. Consequently, the scope of the guidance would apply not only to the exchangeability of Venezuelan local currency, but also to other currencies. Furthermore, the proposed guidance would also apply, to single transactions, and

not only for translating financial statements of foreign operations for the purpose of consolidation.

EFRAG's DCL

32 In the DCL, EFRAG initially assessed that the proposals may have a positive impact on financial reporting under IFRS, may reduce the divergence when a currency lacks exchangeability and may be expected to lead to more transparency regarding accounting policies applied.

33 Nevertheless, EFRAG proposed the IASB to clarify the relationship between the notion 'normal administrative delay' and the definition of the spot exchange rate provided in paragraph 8 of IAS 21, to explain that `normal administrative delay' does not prevent the immediate fixing of the exchange rate as required by the definition.

34 Furthermore, EFRAG proposed the IASB to provide a numeric example to guide preparers on how the estimation process should look like in practice.

35 EFRAG also sought constituents views on:

(a) the usage of unofficial or "black" market currency rates when estimating spot exchange rates;

(b) the methods they currently use to adjust exchange rates of currencies that lack exchangeability;

(c) eventual further information needs regarding the situations where a currency lack exchangeability.