IFRS Emerging Economies Group Zimbabwe Submission Paper

Financial Reporting Challenges in Zimbabwe

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NB: *The paper is compiled on issued captured by participating in local IFRS standard setting, consultancy to various reporting entities and participating in market seminars on matters of reporting.*

Introduction

Financial reporting has been a challenge in Zimbabwe in the past years due to the various changes in the economy. The issues listed below are some of the challenges that are being faced in Zimbabwe in relation to financial reporting. Inflation adjusted financial reports in Zimbabwe are generally regarded as not useful since 2018 to date. If financial information is to be useful, it must be relevant and faithfully represent the substance of the economic phenomenon it purports to represent. Unfortunately, a series of events have happened in Zimbabwe that have made full compliance with IFRS difficult, if not impossible. The following being the key challenges prohibiting IFRS compliance in Zimbabwe:

1. Long term lack of Exchangeability between the USD and the ZWL.

Zimbabwe has various currency challenges as a result of hyperinflation and lack of foreign currency liquidity to fund imports. The Zimbabwe dollar was demonetised due to the 2006 to 2008 severe hyperinflation and was replaced with a multi-currency regime from 2009. In 2016, the government of Zimbabwe introduced and pegged the bond notes alongside the US$ at 1:1. The ZWL$ was pronounced as the mono legal tender in Zimbabwe in June 2019, ending the multi-currency regime. Unfortunately, the ZWL$ was already hyperinflated and Zimbabwe was pronounced by the PAAB as a hyperinflation economy by July 2019. The multi-currency regime was reintroduced in March 2020 as a covid measure but with strict conditions for use and pricing of goods and services. Since, Zimbabwe had no legal currency since 2016, the official exchange rate of 1:1 was used and subsequently the interbank rate system was introduced in July 2019 but was abandoned in March 2020 when it was pegged to US$1:ZWL$25. The auction system was launched end of June 2020 as a currency price discovery measure. In May 2022 the Willing-Buyer-Willing Seller (WBWS) rate was introduced alongside the auction rate system. The official exchange rates are failing to hold as market players cannot access the scarce foreign currency at those rates and many players obtain foreign currency in over-the-counter market at alternative rates. The official exchange rates are frequently recalibrated by the central bank to catch-up with over-the-counter exchange rate but are not floating.

Three issues emanate from the above scenario that has been the core challenge of full compliance with IFRS:

a) Determination of functional currency

- Functional currency became an issue from 2016 when the bond note (aka RTGS) was introduced as an electronic currency, where there was no foreign currency cash and nostro to back it. By 2017 most transactions had become electronic but laws and regulations required that reporting be done in US as the functional and reporting currency. The use of US$ as the functional currency in 2017 and 2018 became an area of contention and failure to comply with IAS 21, especially, failure to identify the change in date of change in functional currency.
- Whilst the 2019 pronouncement of ZWL$ as the legal tender appeared to rectify the functional currency issue for 2019 reporting, the re-introduction of the multi-currency in March 2020 and the continued free fall in value, due to severe hyperinflation of the ZWL$, has caused the US$ to be the currency of choice for many entities in Zimbabwe. Still many entities are still using the ZWL$ as their functional currency for reporting purposes, whereas a significant (more than 80%) number of their transactions are now being carried out in US$. Thus, the challenge of the appropriate date of change in functional currency has become critical again and also the date of change in that functional currency. Some of these entities are required by law to only report in ZWL$ as both the functional and presentation currency.
- Furthermore, in the second half of 2022 moving into 2023, the Zimbabwean Government introduced measures to cab hyperinflation, including the temporary halting of payments to contractors, payment of ZWL$ portion of taxes strictly in ZWL$ to name a few, which resulted in the scarcity of the ZWL$. These measures forced the economy at large to transact largely in US$ which resulted in a number of entities considering to reassess their functional currency. Since the decimation of the ZWL$ by hyperinflation, Zimbabwe recently introduced a new currency, which is a fiat currency, Central Bank Digital Currency (CBDC), said to be backed by physical gold kept by the reserve bank. If the zig digital currency works then the multicurrency regime will be abolished again. This has led to some Zimbabwe entities being reluctant to reassess their functional currency even though they are functional currency has largely changed to US$.

b) ZWL$ lack of exchangeability to other currencies

- Lack of exchangeability arises from the fact that the regulated exchange rate system, i.e., pegged exchange rates, auction system and interbank rates, are used as forex allocation for priority national needs, fail to satisfy most of the market players' foreign currency needs. This is satisfied in the over the counter. The legal exchange rates are not market determined but are rather enforced by various statutes with presidential decree.

- This lack of exchangeability has resulted in challenges on various transactions and balances denominated in foreign currency, such as: valuation of Legacy debts (Blocked Funds), investment property, unlisted shares and shares suspended from trading on the Zimbabwe Stock Exchange.
- On 15 August 2023, the International Accounting Standards Board (IASB) issued “Lack of Exchangeability” which amends IAS 21, effective 1 January 2025. The amendment is expected to address accounting challenges associated with is long-term lack of exchangeability to other currencies and provide Zimbabwe with a window to achieve IFRS compliance.
- Considering the pervasiveness of the matter to Zimbabwe (see other sections where lack of exchangeability also features), reporting entities seem reluctant in applying the amendment early considering the effective date of application is 1 January 2025 and the statutory directives that seem to giving directives on the matter. The statutory directives are issued by the monetary and fiscal authority rather than the accountancy regulator.

c. Cessation of Hyperinflation Accounting – many entities are still preparing hyperinflation financial statements under IAS 29, when in substance they should cease due to change in functional currency to a currency that is not hyperinflationary. We note that the cessation of hyperinflation accounting is not only caused by inflation stability in the economic environment but also by change in functional currency of the entity to a non-hyperinflation currency. Many market participants are still preparing inflation adjusted accounts, even though their functional currency have in substance changed to US$, due to statutory and regulatory requirements, and tax motivations. This has largely caused financial statements to be unfaithfully stated and not useful to users.

d. Impact of change in functional currency on new standards implementation (e.g. IFRS9, IFRS15, IFRS 16, IFRS17)- Zimbabwe has adopted new standards but it appears that change to functional currency does fundamentally affects the outcomes when currency change especially in hyperinflationary environment. Guidance may be required from IASB on impact of change in functional currency to new standards implementation.

2. Continue hyperinflation status of Zimbabwean economy and the application of IAS 29.

Due to the continued hyperinflation in Zimbabwe, organisations are to report the financial statements while applying IAS 29. This is to allow comparability of the financial performance of an organisation. This process on its own is a very complex to accountants and tedious. The challenge presented by reporting using IAS 29 in Zimbabwe is that general price index (GPI) that was being used prior to March 2023 was out of touch with the obtaining economic phenomenon. The GPI being used was the Consumer Price Index (CPI), which measured the percentage change in the price of a basket of goods and services consumed by households. The change in prices in ZWL$ was largely influenced by the ZWL$ over-the-counter exchange rate to the US$. The CPI was not representative of the transactions that business are carrying out, i.e., a household basket is not representative of the basket of a business. Multi-currency transactions are happening in various currencies, however the CPI for ZWL$ is the one used as a GPI representing only ZWL$ transactions. A blended CPI was also calculated for both but could not be used for reporting as reporting is driven by a specific functional currency. The CPI was generally suppressed as it is perceived by fiscal authorities to fuel inflation. That's the application of IAS 29 was largely comprised causing inflation adjusted financial statement to be fail fair presentation.

In March 2023, statistical authorities stopped publishing the normal CPI index, rather they started to produce the US$&ZWL$ blended CPI due to the increased growth of use of the US$ over the ZW$. The Institute of Chartered Accountants of Zimbabwe (ICAZ) issued a guidance paper recommending and not prescribing the use of the Total Consumption Poverty Line (TCPL) which measures the amount that an individual requires to purchase both non-food and food items is published monthly. From ICAZ analysis, they noted that the movement of the TCPL and CPI had an exceedingly strong relationship with a correlation coefficient of 0.99 in the past. Therefore, the estimated CPI post February 2023 would be obtained by adjusting the last published CPI by the monthly movement of the TCPL. However, the TCPL suffers from the same issue of suppression as the CPI for ZWL$. No other representative GPI is available in the market, and the lack of exchangeability worsens the situation as the exchange rate movement which could be a surrogate as indicated by IAS 29 is not possible. **Further, guidance on determination of the GPI could be useful as there is global hyperinflation challenge**. Furthermore, tying in the GPI with the scenarios where there is a change in functional currency, the use of a suppressed GPI results in a lower value of non-monetary assets and some liabilities e.g., lease liability upon the translation of balances. This is due to the differences in movements between the exchange rate and the GPI. The translated balances are not usually fairly presented and therefore to resolve such issues, non-compliance with IFRS is required via the IAS 1 route leading to a readoption of the relevant standard.

3. Consolidation of non-hyper foreign subsidiaries by a hyper parent company in Zimbabwe.

There are Zimbabwean entities that have investments in foreign subsidiaries, which operate in non-hyperinflation economic environments. Various interpretations exist on how the non-hyperinflation subsidiary must be consolidated by a hyperinflation parent entity.

The issue was presented to the IFRIC to be dealt with, and their conclusion was that the varying interpretations were acceptable but also as of June 2023 has been referred to the IASB by recommending that the IASB develops a narrow-scope amendment that addresses the matter. The matter is fortunately not a market pervasive.

4. IFRS 13- fair valuation of non-current assets

Currently in Zimbabwe, the market quoted prices for the non-current assets are mainly in USD, as a currency for value conservation and stable pricing. There is no market for non-current assets that are quoted/priced in local currency. The key valuation areas affected are as follows: unlisted investments, investment properties, property, plant and equipment revaluation. Key challenges include the following aspects:

c. Whether the valuation method should be based on US$ or ZWL$? The valuation over the years has been based on US$ as valuation currency. Unfortunately, the lack of exchangeability gap has exacerbated this matter such that a debate on which currency to use for valuation in the valuation method recently arose. The underlying and unresolved matter seem to be on the appropriateness of functional currency as a guide to the currency of use in the valuation method, which is discussed above.

d. The exchange rate to be used to translate the values in foreign currency to functional and or reporting currency where there is lack of exchangeability. The complaints come as the translation based on official rates are sometime half of what the over-the-counter market participants would value the same assets.

e. Generally, the variations in valuation referred above does affect the valuation and consideration in mergers and acquisitions transactions, as the audited financial statements do not corroborate perceived over-the-counter values which the principals are willing to transact at.

There is varying application of IFRS 13 in the valuation of the above aspects and a cause for non-compliance with IFRS. To sidestep this issue, entities in Zimbabwe have resolved to valuing non-current assets in their functional currency to avoid audit qualifications relating to the exchange rate. However, the significant change functional to US$ has worsened the matter.

5. **IFRS 16 AND IAS 21 and IAS 29 – Lease accounting**

Lease accounting is pervasive in the Zimbabwean market, especially from the lessee perspective. The issue is the impact of hyperinflation and exchange rates where the currency lacks exchangeability, causing significant accounting mismatch. The right of use asset (ROUA) and the lease liability are affected as follows:

1. Change in contract terms – to combat hyperinflation lessors have taken a number of approaches:
   i. Change the currency of the lease contract to foreign currency (e.g. US$).
   ii. Index to US$ rent payable in local currency or make monthly reviews of the lease payments.
   iii. Use of short-term lease agreements

A number of challenges arises from these interventions, i.e., whether the changes are must be accounted for as lease modification or remeasurement adjustments or whether the leases should be classified as foreign denominated contracts. Foreign leases exacerbate the complexity in lease accounting, before considering the unreliable exchange rates challenge as well as the accounting for the exchange losses in particular circumstances.

2. For ZWL$ leases accounting, the ROUA is a non-monetary asset and its value is being depreciated and restated using subdued CPI, whereas the lease liability is not restated at year end. If the lease is foreign currency denominated, the ROUA is not translated but the lease liability is restated at reporting date. Significant accounting mismatch and disparities arise on this matter which is affecting profitability and mostly key ratios like acid test and debt to equity ratios.

6. IFRS 9&17 – discount rate challenges due to lack of bond market

Currently, there is no active debt instrument market as a hyperinflation environment, therefore the discount rate will be difficult to determine. The actuary is estimating the discount rate to be used, or alternative methods are used. **How can an entity estimate the discount rate required by IFRS 17 and IFRS 9 where there is no active observable market?**

7. IFRS 1 – General Non-compliance with IFRS in Zimbabwe

Since 2016 to date, entities where mandated to report according to the compulsory laws which was not in accordance with IFRS as indicated above. Most entities admitted to '*compliance with IFRS except for IAS 21*' in their annual reports. Most financial statements were qualified based on this matter but unqualified opinions are beginning to be issued, based on the perception that compliance with IFRS is achieved due to passage of time without resolving the cause of qualification in opening balances. The impact of non-compliance with IFRS on opening balances is believed to be washed away if the subsequent financial positions are largely based on IFRS. A number of issues therefore arises on this matter:

a. Compliance with IFRS is reported without the strict re-adoption of IFRS as guided by IFRS1- *First-time Adoption*. That's financial reports purport to be IFRS compliant when they are not. Zimbabwe re-adopted IFRS financial statement in 2011 after exiting in 2008 due to severe hyperinflation, two years after multi-currency, however, this process has not been done for areas that caused the recent failure to explicitly comply with the whole of IFRS, i.e., the 2019 to 2021 non-compliance.
b. New challenges affecting the same area of non-compliance (IAS 21) are still prevalent but in different forms and nurture, e.g. in 2019, the issue was that entities were forced by law to report for 2017 and 2018 using the US$ as both functional and presentation currency, at a rate of 1:1, when the economic substance suggested that pseudo digital local currency (RTGS) was the functional currency and was largely not exchangeable at 1:1. Currently, due to severe hyperinflation, the market is largely abandoning ZWL$ to transact in US$ and due to lack of exchangeability of the ZWL to the US$. Entities are still not able to comply with IFRS due to these new events, hence, further complicating IFRS re-adoption as there is no certainty and resolution for the matters that caused failure to comply with IFRS before.

Key issues, is **how does an entity achieve compliance with IFRS without going through IFRS 1 and without resolution of the conditions that has caused the non-compliance. How should the new events causing the non-compliance be addressed? At what point should Zimbabwe or specific entity re-consider readoption of IFRS?**

Main IASB Issues to consider providing more guidance on:

- There is need of further guidance on identifying change in functional currency especially in a hyperinflationary environment, i.e. functional currency could change as the economic participants chose other means of transacting and storing value other than the hyperinflationary currency. How should potential policy changes be taken in case where an entity is considering functional currency change.
- Supplementary financial reports – can an entity achieve fair presentation by publishing complementary financial reports in a stable currency in case where presentation currency fails to achieve fair presentation. How could supplementary information be regarded where fair presentation is at stake in main financial statements.
- The influence of laws and regulation with compulsory reporting requirements contrary to IFRS is an area that also need consideration. Non-compliance with IFRS due to compulsory application of country laws and regulations disclosures may be required.
- Compliance with IFRS – guidance on whether passage of time alone can achieve IFRS compliance.
- Guidance may be required from IASB on impact of change in functional currency to new standards implementation. Should there be a new readoption in the new functional currency.