IFRS

Staff Note

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Project **Emerging Economies Group**

Topic **Foreign currency accounting**

Objective of this paper

1. The existing IFRS on foreign currency translation (IAS 21 *The Effects of Changes in Foreign Exchange Rates*) is based on the US standard. Some have criticised IAS 21 as designed for companies that operate in a reserve currency. Recent volatility in exchange rates, especially in emerging economies, has led some to ask that this standard be reconsidered.

2. The International Accounting Standards Board (IASB) is undertaking agenda consultation to gather views, from all those interested in financial reporting on the priority of individual projects or agenda areas. The Board expects to use Emerging Economies Group (EEG)'s inputs on the foreign currency issues in considering a potential agenda project.

3. This paper provides basis for discussion on whether a project for amendments to foreign currency accounting should be limited to narrow implementation issues or should address questions of currency accounting more comprehensively. This paper also summarises different views on whether foreign currency accounting is suitable for next IASB agenda referring to its agenda criteria.

Structure of the paper

4. The paper is organised as follows:

(a) background;

(b) project scope; and

(c) satisfaction of IASB agenda criteria.

Background

5. Much of recent attention to IAS 21 comes from the experience of countries during the financial crisis. Entities encounter difficulties due to the increased volatility of the foreign exchange market that is compounded by global financial crises.

6. In particular, one of the most recurring, controversial accounting issues that emerging economies raise in times of such crises is the requirements to translate foreign currency monetary items at the closing rate (paragraph 23 of IAS 21) and recognise the exchange differences arising on monetary items in profit or loss for the period in which they arise (paragraph 28 of IAS 21).

> 23 At the end of each reporting period:
>
> (a) foreign currency monetary items shall be translated using the closing rate;
>
> (b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and
>
> (c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined.
>
> 28 Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32.

7. Some argue that applying the closing rate may misrepresent the economic substance of an entity; and that profit or loss is unduly swayed by the closing rate irrelevant to the entity's performance; and major financial ratios fluctuate without what they consider to be real changes in the entity's financial status.

8. At the Board's request, a group of national standard-setters led by the Korea Accounting Standards Board (KASB) has been exploring foreign currency issues. These issues can be found at separately attached papers[1]. In addition, another paper about the accounting for foreign exchange transactions, which capture issues that people have raised with the IASB, is attached[2].

Project scope

9. When adding new projects to the IASB's agenda, the Board will decide whether a comprehensive project is needed or a narrow, targeted improvement would suffice. There might be wide range of opinion on the project scope but we can categorise these different views as follows.

- (view 1) comprehensive review for fundamental revision
- (view 2) targeted review for improvement on specific issues
- (view 3) narrow-scope review for minor, operational issues

View 1: comprehensive review

10. This view is to reconsider comprehensively most, if not all, aspects of the existing standards of accounting for foreign currency accounting, including the idea of a functional currency and the definition of a foreign operation. Some are calling for a comprehensive review of foreign currency accounting to address the entities' demands.

11. Those who hold this view is argue that it is difficult to understand conceptually the basis for the current translation requirement in IAS 21, the requirement for "Reporting at the ends of subsequent reporting periods" as stated in paragraph 23. They argue that IAS 21 provides insufficient background information as to why the translation method in paragraph 23 was selected over other possible alternatives.

[1] Research Report: Foreign Currency Accounting Issues, Korea Accounting Standards Board
[2] Foreign Currency Discussions, Wayne Upton

12. They also think that objective of foreign currency translation, which is not explicitly set out in IAS 21, should be included in IAS 21 because a particular translation method can only be justified by meeting the objective of foreign currency translation in the first place. Thus it is necessary to review IAS 21 comprehensively in order to address the topic of ‘objective of foreign currency translation’.

13. They reason that conceptual clarification of the translation requirements in IAS 21 will be useful in reviewing the relevance of possible alternatives in the future. For instance, to examine whether it is more appropriate to recognise a gain or loss on a monetary item from changes in foreign exchange rates in other comprehensive income instead of profit or loss in the period in which they arise, defining the objective of translation and considering the relevance in accordance with the objective would be helpful.

14. They also argue that a comprehensive review is needed to address other situations in which exchange rates interact with other IFRSs. These might include measurement, consolidation, financial statement presentation and financial instruments.

View 2: targeted review

15. This view is to limit a project scope to addressing targeted areas in order to resolve urgent issues on foreign currency accounting. Even though comprehensive review is able to develop higher quality of standards, it will take too long time to settle foreign currency issues.

16. Some jurisdictions that have experiences of difficulty due to volatility of exchange rates have great interest in a targeted review for improvement on recognition of exchange difference. They maintain that translating all foreign currency monetary items using the closing rate leads to unnecessary volatility in reported income. They would like to consider possible alternative treatments in translating foreign currency items and transactions, for example, using alternative foreign exchange rates, recognizing exchange differences as OCI and recognizing natural hedges.

17. They also argue that the IASB cannot afford to review IAS 21 fundamentally considering constraints such on resources. So they think the IASB needs to focus on the selective issues in order to be successful with this project.

View 3: narrow-scope review

18. This view is to concentrate on how to resolve the implementation issues which will lead to annual improvement, not the full revision. Some consider the issues raised by the entities that experience volatility of exchange rates merely as a matter of foreign exchange market operation rather a matter of foreign currency accounting requirement. In fact, they believe that the current foreign currency accounting clearly shows the economic substance of entities and thus view the deteriorated financial statements during an economic crisis as a natural consequence.

19. They argue that not every country who is experiencing FX volatility is asking to change IAS 21 fundamentally. They maintain that IAS 21 may not be perfect, but most people learned to live with it. They maintain that the current translation methods that distinguish the monetary and non-monetary items have caused no particular problem. Accordingly, they think that the issues of concern about IAS 21 can be solved through annual improvement projects.

20. Some others recommend that, if the issues of concern about IAS 21 must be addressed, they would be best addressed in the context of other projects such as measurement phase of the conceptual framework project, consolidations, financial statement presentation, and financial instruments. They believe that the examples arising in a foreign exchange context that are concerns in some jurisdictions might be useful in informing the debate in respect of all of these projects.

Satisfaction of IASB agenda criteria

21. When selecting projects, the Board will assess agenda proposals against the agenda criteria, including cost-benefit considerations (see appendix A). They

will also take into account the objectives of the IFRS Foundation to ensure appropriate overall balance.

22. Entities in jurisdictions that do not use a reserve currency and actively engage in foreign currency transactions have complained of difficulties caused by the significant fluctuation of the foreign exchange market. They also argued that there is a need to amend the accounting standards associated with foreign currency accounting. For instance, they argued that the current accounting standards related to foreign currency translation might not reflect the true economic substance of long-term assets and liabilities denominated in foreign currency because long-term items are translated at the closing rate even when the rate is set at an abnormal level and is expected to revert to a normal level before the redemption.

23. On the other hand, some consider the issues raised by entities merely as a matter of foreign exchange market operation rather a matter of foreign currency accounting requirement. In fact, they think that the current foreign currency accounting clearly shows the economic substance of entities and thus view the deteriorated financial statements during an economic crisis as a natural consequence.

24. Accordingly, to address the two conflicting views properly, discussion on whether foreign currency accounting is suitable for IASB agenda criteria would be meaningful and help seek for alternatives to current IAS 21. This section refers to agenda criteria set out in the IASB's *Due Process Handbook*[3] and summarise two different views to consider in deciding whether to add an item to the agenda.

25. The established agenda setting criteria, as set out in the IASB's *Due Process Handbook*, are:

    (a) The relevance to users of the information involved and the reliability of information that could be provided

    (b) Existing guidance available

[3] The IASB Due Process Handbook, paragraphs 55 to 60

(c) The possibility of increasing convergence

(d) The quality of the IFRSs to be developed

(e) Resource constraints.

Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided

26. Criterion 1 considers whether the project addresses the needs of users across different jurisdictions. The criterion considers the following factors:

- Changes in financial reporting and regulatory environment: international relevance
- pervasiveness
- urgency
- consequences of not adding the project to the agenda

View 1

27. An argument for view 1 is that issues on foreign currency have emerged as a result of changes in the financial reporting environment and regulatory requirements across jurisdictions. In times of international economic crisis, cases were witnessed where the foreign exchange rates became extremely volatile to an extent that it may not be seen as prices determined in the normal course of trade by reasonable market participants. Moreover, it has not been that long since many of the emerging economies started to adopt a floating exchange rate system. Brazil, India, Mexico, Russia and Korea adopted a full floating exchange rate system only in 1999 as they weathered the Asian financial crisis in the late 1990s. With the adoption of a floating exchange rate system, volatility of these emerging economies' foreign exchange rates grew.

28. Some people who take this view think that foreign currency accounting issues are not specific to emerging economies. Advanced economies have already experienced significant fluctuation in their exchange rate since 1970s when they adopted floating exchange rate system. Also, in 2008 Canadian dollar and Australian dollar devalued significantly. Therefore, although requests for

amendment are generally voiced by companies in emerging economies, foreign currency accounting issues might be relevant to all companies across all jurisdictions.

View 2

29. Some exporting jurisdictions such as Canada, Australia and South Africa disagree that IAS 21 should be amended even though these jurisdictions have not been immune from large changes in the exchange rates for their currencies. They believe that many entities and users are well accustomed to dealing with volatility of foreign currency. Consequently, there might be a widespread view that IAS 21 does result in financial reporting that faithfully reflects economic circumstances.

Criterion 2: Existing guidance available

30. Criterion 2 considers whether the project will address an area on which the existing guidance is insufficient.

View 1

31. Some argue that with regard to the requirement of translation of monetary items at the closing rate, IAS 21 does not provide guidance as to how to apply the “closing rate” in times of “financial crisis”. However, additional guidance would have to be provided if it is decided that a separate accounting treatment should be required or permitted during a “financial crisis” situation. For example, guidance about the definition of a situation that requires a separate accounting treatment as well as of the “closing rate” would be required.

View 2

32. The IFRIC list of rejected agenda topics lists only one IAS 21 item. That means many constituents do not feel the need for guidance although the IFRIC has dealt with several issues that involve the interaction between foreign currency and other issues, most notably IAS 32 and 39.

Criterion 3: The possibility of increasing convergence

33. It is not expected that foreign currency accounting project would bring convergence on a large scale as most national accounting standards including US GAAP are principally similar to IAS 21 in terms of translating monetary items.

Criterion 4: The Quality of the IFRSs to be developed

34. Criterion 4 considers the qualitative aspects of the standards that are proposed to be developed. This criterion considers the following factors:

- availability of alternative solutions
- cost/benefit considerations
- feasibility

View 1

35. Although potential solutions have not been sufficiently developed, the focus of project will be to seek for alternative exchange rates other than the closing rate or to recognise exchange difference in other comprehensive income (OCI) in order to apply in the case of abnormal exchange rate movement.

View 2

36. It is unlikely that a provision denominated in foreign currency would be translated at any rate other than the closing rate. In addition, some underlying matters of principle surrounding OCI need to be resolved before we can sensibly consider changing current accounting for foreign currency transaction.

Criterion 5: Resource constraints

37. Criterion 5 considers whether there are sufficient resources to undertake the project. The criterion considers the following factors:

- availability of expertise outside the IASB
- amount of additional research required

- availability of resources

View 1

38. The IASB has adequate resources and expertise outside the IASB from advanced economies which already had much discussion about foreign currency accounting in the past. Also, the foreign currency working group of NSSs will support the IASB by continuing further research based on basic research result to date.

View 2

39. Some people disagree that there is sufficient research about the issue to form a basis for beginning the project. Furthermore, they think that other projects need to be dealt with a priority with the resources available.

Question

Questions to the Emerging Economies Group
Question 1 – Which of the three views of project scope do you support and Why?
Question 2 – Do you agree that a foreign currency project should be added to IASB agenda? Why or why not?
Question 3 – Do you have any other comments on foreign currency accounting?

Appendix A: IFRS Foundation objectives and IASB agenda criteria

The identification of projects to include in the IASB's agenda is made within the context of the objectives of the IFRS Foundation and the IASB's established agenda criteria. The objectives of the IFRS Foundation, as set out in the Constitution[4], are:

(a) to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions.

(b) to promote the use and rigorous application of those standards.

(c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings.

(d) to promote and facilitate adoption of International Financial Reporting Standards (IFRSs), being the standards and interpretations issued by the IASB, through the convergence of national standards and IFRSs.

The established agenda setting criteria, as set out in the IASB's *Due Process Handbook*[5], are:

- The relevance to users of the information involved and the reliability of information that could be provided
- Existing guidance available
- The possibility of increasing convergence
- The quality of the IFRSs to be developed
- Resource constraints.

The relevance to users of the information involved and the reliability of information that could be provided

The IASB considers whether the project would address the needs of users across different jurisdictions, taking into account the following factors:

• changes in the financial reporting and regulatory environment—whether the issue is internationally relevant, and has emerged as a result of changes in the financial reporting environment and regulatory requirements across jurisdictions.

[4] The IFRS Foundation's Constitution, paragraph 2
[5] The IASB Due Process Handbook, paragraphs 55 to 60

- pervasiveness—whether the issue is one that (a) affects more than a few entities and more than a few jurisdictions, (b) gives rise to problems that are frequent and material and (c) will persist if not resolved.

- urgency—whether requests have been received from constituents, with reasonable justifications, that the IASB should address the issue as a matter of priority.

- consequences—whether the absence of an IFRS might cause users to make suboptimal decisions.

Existing guidance available

After assessing the significance of an issue, the IASB considers whether the project will address an area on which existing guidance is insufficient. The following aspects are taken into account:

- No guidance exists.

- There is diversity in national standards, which results in a lack of comparability in financial reporting.

- There is diversity in practice, or IFRSs are difficult to apply because they are unclear or unnecessarily complex.

- The cost of complying outweighs benefits to users, or

- The IFRSs are out of date and the information they generate no longer appropriately reflects economic conditions or results.

The possibility of increasing convergence

As specified in the Constitution, the IASB is tasked with bringing about the convergence of national and international accounting standards to high quality solutions. Therefore, in parallel with the review of existing guidance on an issue, the IASB considers whether undertaking a project would increase the possibility of achieving the convergence of the accounting standards in different jurisdictions.

The quality of the IFRSs to be developed

After evaluating the existing IFRSs including the prospects of further convergence, the IASB considers the qualitative aspects of the IFRSs that are proposed to be developed. The following factors are taken into account:

- availability of alternative solutions—whether when an issue is addressed, there are alternative solutions to improve *relevance, faithful representation, application of fundamental qualitative characteristics, comparability, verifiability, timeliness and understandability* in financial reporting, and it is likely that sufficient IASB support and approval will be attainable for IFRSs developed.

- cost/benefit considerations—whether it is likely that the expected benefits to users of the improved financial reporting will exceed the costs of implementation.

- feasibility—whether it is feasible to develop a technically sound solution within a reasonable time period without awaiting completion of other projects.

Resource constraints

The IASB then considers whether there are sufficient resources to undertake a project in its agenda. The following factors are taken into account:

- availability of expertise outside the IASB—whether there is expertise available at the national level that the IASB can employ to address the issue; or certain accounting standard-setters have already committed resources to the project or have undertaken research to address the issue.

- amount of additional research required—whether there is sufficient research about the topic to form a basis for beginning the project, although more may be needed.

- availability of resources—whether there are adequate resources and expertise available to the IASB and its staff to complete the project and undertake the necessary due process activities.