

2 December 2011

Mr. Hans Hoogervorst, *Chairman*
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH
United Kingdom

Dear Mr. Hoogervorst,

**Agenda Proposal for Foreign Currency Accounting:
The Amendment to IAS 21, *The Effects of Changes in Foreign Exchange Rates***

On behalf of the Korea Accounting Standards Board (KASB), I would like to express my heartfelt gratitude for your sincere interest in the issues of each country and your constant efforts to make IFRSs a set of high quality global standards.

The KASB would like to request the IASB to adopt foreign currency accounting as an official post-2011 agenda.

Foreign currency accounting is a matter of great importance to emerging economies including Korea, and many entities have continuously raised concerns that the current accounting standard related to foreign currency translation (IAS 21) does not reflect the true economic substance when the foreign exchange rates become highly volatile in times of financial crises.

The KASB has thus conducted “Foreign Currency Accounting Project” since 2010 to address the issues raised by entities and has reached a conclusion that some parts of current IAS 21 need amendment. The Agenda Proposal for the Amendment to IAS 21 enclosed herein proposes narrow-scope amendment to IAS 21. The following is an overview of our Proposal:

IAS 21 can be improved by providing guidance for rare circumstances. Current requirement of translating foreign currency monetary items at the closing rate (paragraph 23 of IAS 21) should address rare circumstances, in which an alternative rate to the closing rate should be required or permitted. It is appropriate to use the closing rate as far as the closing rate reflects the market’s best estimate of future events that affect the currency, considering an analogy to paragraph BCZ47 of the Basis for Conclusions on IAS 36 *Impairment of Assets*.

However, in our view, using the closing rate in rare circumstances would not be appropriate since the closing rate does not reflect the market’s best estimate of future events in such circumstances. Rare circumstances are the cases where all of the following conditions are met: i) Foreign exchange market classified as a “thin market”, ii) Significant exchange rate fluctuation due to exceptional and temporary external shocks such as financial crises, and iii) Long-term foreign currency items.

We would appreciate your taking into special consideration our proposal during the deliberation on new agendas in accordance with the due process of “Request for Views: 2011 Agenda Consultation” recently published by the IASB.

For your reference, we have attached as Appendix to this letter our comprehensive review of IAS 21 (please refer to the separate document with the title of “Appendix – A Research Report on Foreign Currency Accounting”), based on our “Foreign Currency Accounting Project,” in particular, areas that require long-term reviews. For example, the comprehensive review covers the objective of foreign currency translation.

We sincerely hope you would add foreign currency accounting to the IASB’s future agendas.

Please do not hesitate to contact us if you have any inquiries regarding our proposal. You may direct your inquiries either to me (suklim@kasb.or.kr) or to Mr. Jae-Ho Kim (jhkim@kasb.or.kr), Senior Technical Manager of KASB.

Yours sincerely,



Mr. Suk-Sig (Steve) Lim
Chairman, Korea Accounting Standards Board

Cc: Sungsoo Kwon, Senior Director of Research Department

Agenda Proposal for Foreign Currency Accounting:
The Amendment to IAS 21, *The Effects of Changes in Foreign Exchange Rates*

Summary

I. Background

- Recurring requests from entities in emerging economies for amendment on foreign currency accounting whenever financial crises occur
 - ✓ Misrepresentation of an entity's financial status and performance due to translation of foreign currency monetary items at the closing rate (refer to Figures 1-1 and 1-2)

II. Current IAS 21, *The Effects of Changes in Foreign Exchange Rates*

- Translate foreign currency monetary items at the closing rate (i.e. spot rate at the end of the reporting period)

III. Overall Direction of the Research

- Using the closing rate per se cannot be a principle
- More basic principle: The rate should reflect the best estimate of the future rate at the time of receipt or settlement of foreign currency monetary items
 - ✓ Analogised to the Basis of Conclusions¹ in IAS 36, *Impairment of Assets*²

¹ The BC in IAS 36 was made by the IASC, predecessor of the IASB. Therefore, it can be understood that IAS 21 which was issued prior to IAS 36 should have consistent conclusions with IAS 36.

² The relevant BCs in IAS 36 are [emphasis added]:

BCZ46 In response to comments from field test participants, paragraph 54 of IAS 36 includes guidance on calculating the value in use of an asset that generates future cash flows in a foreign currency. IAS 36 indicates that value in use in a foreign currency is translated into the reporting currency² using the spot exchange rate at the balance sheet date.

BCZ47 **If a currency is freely convertible and traded in an active market, the spot rate reflects the market's best estimate of future events that will affect that currency.** Therefore, the only available unbiased estimate of a future exchange rate is the current spot rate, adjusted by the difference in expected future rates of general inflation in the two countries to which the currencies belong.

BCZ49 To use a forward rate to translate value in use expressed in a foreign currency would be inappropriate. This is because a forward rate reflects the market's adjustment for the differential in interest rates. Using such a rate would result in double-counting the time value of money (first in the discount rate and then in the forward rate).

- ✓ In most cases, the closing rate reflects the best estimate of future events; however, in rare circumstances, it is questionable

IV. Proposal

- Add requirements addressing rare circumstances where the closing rate does not represent the best estimate
- Limited scope amendment
 - ✓ Complement to the principles in IAS 21
- Rare circumstances should be limited to the cases where all of the following conditions are met:
 - ✓ Foreign exchange market classified as a “thin market”³
 - ✓ Significant exchange rate fluctuation due to exceptional and temporary external shocks such as financial crises⁴, and
 - ✓ Long-term foreign currency items⁵
- Apply the alternative rate that replaces the closing rate in rare circumstances
 - ✓ Adjusted historical rate model: the exchange rate using a long term trend line obtained from historical data (e.g. moving average rate)
 - ✓ Expected rate model: the exchange rate that represents the normal rate over the long-term, reflecting the best estimate of future events

V. To be discussed further

BCZ50 Even if a currency is not freely convertible or is not traded in an active market—with the consequence that it can no longer be assumed that the spot exchange rate reflects the market’s best estimate of future events that will affect that currency—IAS 36 indicates that an enterprise uses the spot exchange rate at the balance sheet date to translate value in use estimated in a foreign currency. This is because IASC believed that it is unlikely that an enterprise can make a more reliable estimate of future exchange rates than the current spot exchange rate.

³ “Thin market” represents a market where numbers of market participants or market activities are relatively low. For example, if a market has low ‘turnover of foreign currency activities compared to GDP’ or government plays a significant role as market participant, such market is classified as “thin market”. Also analyses can be found that “thinness” makes the market more vulnerable to external shocks such as financial crisis.

⁴ Since the IASB amended IFRS in 2008 to permit items measured at fair value to be measured at amortised cost in “rare circumstances”, a special accounting may also be considered for foreign currency accounting in “rare circumstances”, consistent with the 2008 amendment.

⁵ Further discussion may be necessary as to how to make a distinction between short-term and long-term, but the criteria for such distinction used in IAS 1 “Presentation of Financial Statements” may be applicable.

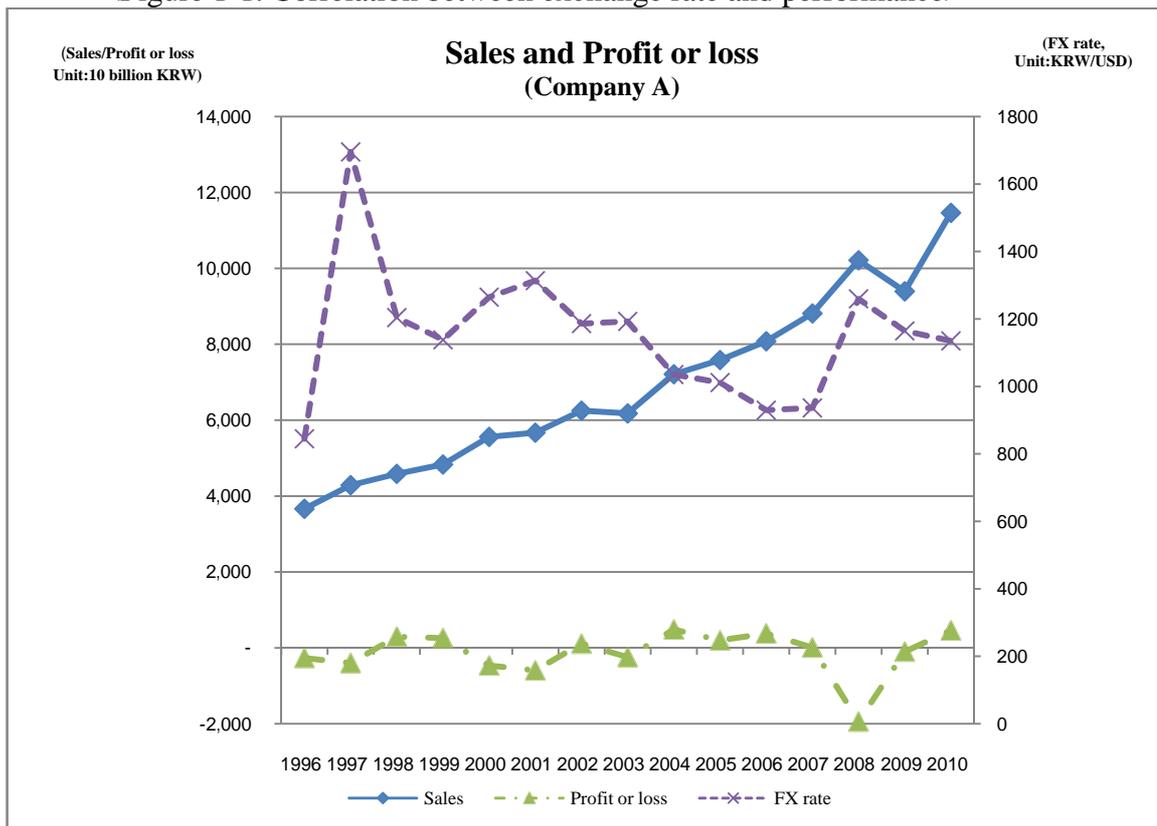
- In-depth study on microstructure of foreign currency market utilizing research in the field of economics, and development of concrete indicators of determining a “thin market”
 - ✓ Examination is required to determine the characteristics the alternative rate should be comprised of
 - ✓ However, further discussions would be carried out more efficiently after the IASB takes foreign currency accounting as a future agenda
 - ✓ Once the IASB acknowledges the need for amendment, the IASB may resort to resources and expertise outside the IASB if necessary

I. Background

Entities Raising Issues in Times of Financial Crises

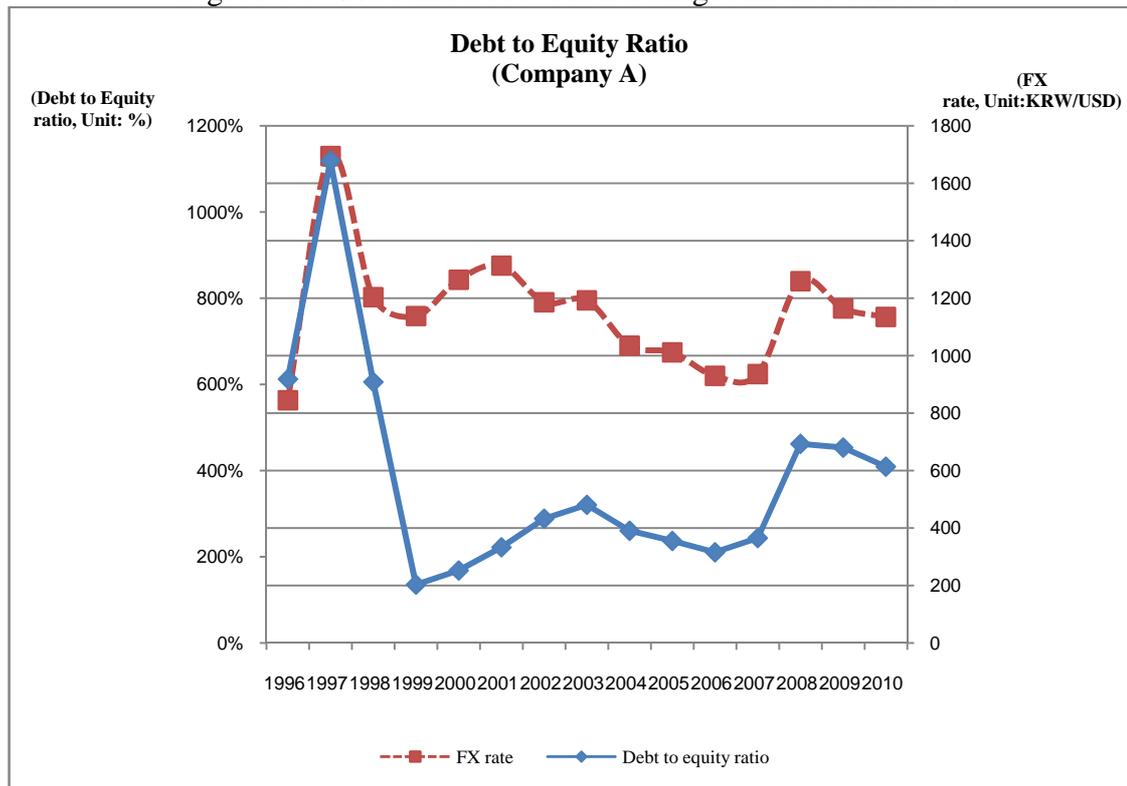
- 1.1 Entities encounter unexpected difficulties due to the increased volatility of the foreign exchange market that is often compounded by financial crises.
- 1.2 In particular, one of the most recurring, controversial accounting issues that emerging economies raise in times of such crises is the requirement to translate foreign currency monetary items at the closing rate. The argument against this requirement is that applying the closing rate which is determined at an unpredictable level during the financial crises may misrepresent the economic substance of an entity; profit or loss account is unduly swayed by the closing rate irrelevant to the entity's performance (Figure 1-1); and major financial ratios (e.g., debt to equity ratio) fluctuate as if there have been real changes made in the entity's economic substance when in fact there has not been any (Figure 1-2)⁶.

<Figure 1-1. Correlation between exchange rate and performance>



⁶ Some may argue that the economic substance of Company A in Figures 1-1 and 1-2 is accurately reflected since the company's performance deteriorated due to its insufficient hedging activities. However, the assumption that an entity should conduct additional transactions of hedging is irrelevant to the discussion of accounting treatments. Therefore, the determination of whether the financial statements of an entity show the real economic substance should be based on the premise that the entity conducted its transactions according to reasonable decisions.

<Figure 1-2. Correlation between exchange rate and debt ratio>



1.3 On the other hand, some are not convinced by that argument, questioning why the volatility of the foreign exchange rate per se should pose problems. They believe that the current foreign currency accounting standard faithfully represents the economic substance of the effect of a rate change.

Need for Review of Foreign Currency Accounting and Direction of the Review

1.4 Given the two contradictory views, we see the need for review of foreign currency accounting on the basis of the reasons described as below and also propose the direction of the review.

1.5 The underlying reason for using the closing rate to translate foreign currency monetary items would be that the closing rate represents the best estimate of future events that will affect the currency. However, the premise would not hold true in all cases; a closing rate during a certain period of time or in some foreign exchange markets may not represent the best estimate. IAS 36 gives an account of the examples, stating that if a currency is not freely convertible or is not traded in an active market, it can no longer be assumed that the spot exchange rate at the balance sheet date (i.e. closing rate)⁷ reflects the market’s best estimate of future events that will affect that currency (paragraph BCZ50).

1.6 The concept of “thin market”, which is mostly used in academic papers over the analysis of microstructure of foreign exchange markets, also provides a useful indication that there are cases where the closing rate does not reflect the market’s best

⁷ In IAS 21, closing rate is defined as ‘the spot exchange rate at the end of the reporting period’.

estimate of future economic benefit of an entity's cash flows. It is analysed that foreign exchange markets of many emerging economies exhibit the characteristics of "thin market" – a market that is dominated by a small number of market operators rather than many individual participants, or in which a small amount of change in supply and demand significantly affects transaction prices. It is also shown that volatility in the exchange rates of many emerging economies during the financial crises is attributed to the "thinness" of the market. These analyses allow us to argue that the closing rate in emerging economies during the financial crises could not represent the best estimate of future events, provided that the foreign exchange market in the emerging economies is defined as a "thin market", which cannot be treated equally as a "deep and active market".

- 1.7 Admittedly, closing rates from "active markets", in most cases, would represent the best estimate of future events that will affect the currency since most active markets are presumably deep⁸. However, as shown above, it would prove otherwise when there are structural deficiencies in the foreign exchange market (e.g. "thin market") and external shocks such as the financial crises although such cases may be rare. Thus we believe that the IASB needs to provide requirements addressing the rare cases.
- 1.8 The following section of this report describes the rare cases more in detail where the closing rate does not represent the best estimate of future events and proposes to add requirements as to such cases. Further, it explores alternative exchange rates that can represent the best estimate of future events instead of the closing rate when using the closing rate is inappropriate.
- 1.9 This report, however, does not include sufficient review over the microstructure of foreign exchange market from the perspective of economics, so that future study will be necessary in cooperation with economists. Also further study should be undertaken as to what characteristics are required of alternative exchange rates to replace the closing rate.
- 1.10 The following section (II. Proposal) sets out the need for adoption of foreign currency accounting as one of the IASB future agendas and the proposal of alternatives to closing rate by using the criteria for agenda setting included in the IASB Due Process Handbook.

II. Proposal

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

- 2.1 Criterion 1 considers whether the project addresses the needs of users across different jurisdictions. The criterion considers the following factors:
 - (a) Changes in financial reporting and regulatory environment: international relevance
 - (b) pervasiveness

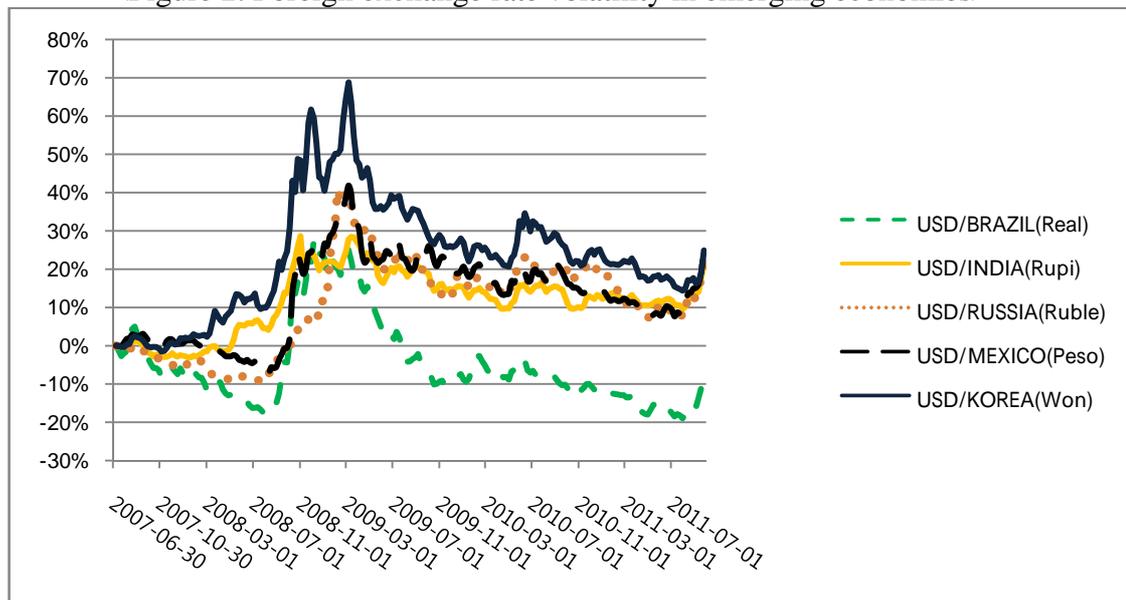
⁸ In this report, the concept of active market includes both thin and deep markets and it is viewed that the closing rate would represent the best estimate of future events in deep and active markets.

- (c) urgency
- (d) consequences of not adding the project to the agenda

International relevance

2.2 Foreign currency accounting has been considered as very important to entities in emerging economies. It is drawing even greater attention as many emerging economies, including Brazil, India, Korea, Mexico, and Russia, adopted the floating exchange rate system after they weathered the Asian Financial Crisis in the late 1990s and the foreign exchange rate volatility is growing larger⁹ as a result of the adoption (Figure 2).

<Figure 2. Foreign exchange rate volatility in emerging economies>



- 2.3 The issues raised by emerging economies are mainly related to translation of foreign currency monetary items. IAS 21 requires all foreign currency monetary items to be translated at the closing rate. Emerging economies are demanding amendment of this requirement since they believe such requirement is unable to reflect the real economic substance in times of crises. In particular, they are arguing that it is not appropriate to translate long-term foreign currency monetary items at a closing rate that have unusually fluctuated during financial crises because such rate tend to recover after a certain period of time.
- 2.4 Considering the issues raised by emerging economies are only relevant to the times of financial crises, the IASB needs to focus on examining whether it can require or permit a special accounting treatment in times of financial crises.

Pervasiveness

⁹ Volatility in Korean Won exchange rate against USD has been increasing since the floating exchange rate system was implemented in 1997. Average daily volatility in Korean Won against USD rose from 0.2% during 1990~1997, the period of pre-floating rate system, to 0.4% during Jan 1998~Sep 2008, the period corresponding to the start of the floating rate system until just before the start of the financial crisis. The volatility having peaked at a level of 1.7% during the period of financial crisis (Sep 2008 ~ Mar 2009), it leveled off at 0.6% during the period of post-financial crisis (Apr 2009 ~ Dec 2010).

- 2.5 The foreign currency accounting issue in times of financial crises is not limited to emerging economies. For economies that use a reserve currency as its functional currency, such as the U.S., the foreign currency accounting issue may not be as important since the volume of foreign currency transactions is likely to be relatively small. However, other advanced economies had to go through severe rate fluctuations in the past since they adopted the floating exchange rate system in the 1970s, and this consequently led to extensive discussions about foreign currency accounting. Examples of such economies include Canada and Australia. Therefore, although entities in emerging economies are taking the lead in demanding amendment of foreign currency accounting, the foreign currency accounting issue should basically be relevant to almost all nations and entities.

Urgency

- 2.6 It would be reasonable to consider foreign currency accounting as one of the “Financial Crisis Project” of the IASB. The IASB has initiated and is currently carrying out the “Financial Crisis Project” to address a number of urgent accounting issues raised by stakeholders during the “financial crisis.” The project includes topics such as comprehensive review of “Financial Instruments” including a proposal to change the impairment principle from ‘incurred loss model’ to ‘expected loss model’, ‘off-balance sheet financing’, and ‘fair value measurement’, and etc.
- 2.7 While these topics are clearly important to entities in emerging economies, the most challenging topic of all for emerging countries during the “financial crisis” has been “foreign currency accounting.” Considering this, “foreign currency accounting” should be addressed on the same footing as other topics in the “Financial Crisis Project.”
- 2.8 Furthermore, the fact that the IASB amended IFRS in 2008 to allow a different accounting treatment in times of financial crises¹⁰, which is to permit an item measured at fair value to be measured at amortised cost, suggests that it may be reasonable to examine the alternative that provides a different accounting treatment for foreign currency accounting in times of financial crises.
- 2.9 In particular, the IASB implicitly defines “financial crisis” as “a single event which is very unlikely to recur within a short period of time” in the 2008 amendment mentioned above. Considering this in relation to long-term foreign currency monetary items, it may be viewed as that a rate change caused by a short-term event of “financial crisis” is very unlikely to affect long-term items at the time of settlement. This is so because the unusual effect induced by such single event will fade away over the long-term. Thus, reflecting such short-term effect on long-term items in profit or loss in the period in which the event occurred would not show the performance of the entity in an adequate manner.
- 2.10 Meanwhile, instability of foreign exchange rate is expected to grow even greater due to the ever increasing international capital flows. Therefore, a situation similar to the

¹⁰ The IASB amended IAS 39 to permit non-derivative financial assets to be reclassified out of the held for trading or available for sale category in rare circumstances. And the rare circumstances are defined as that they arise from a single event that is unusual and highly unlikely to recur in the near term. In other words, the IASB did not explicitly refer to “financial crisis” as one of the “rare circumstances”. Notwithstanding, it could be construed that “financial crisis” is included in the “rare circumstances” considering the intent of the amendment.

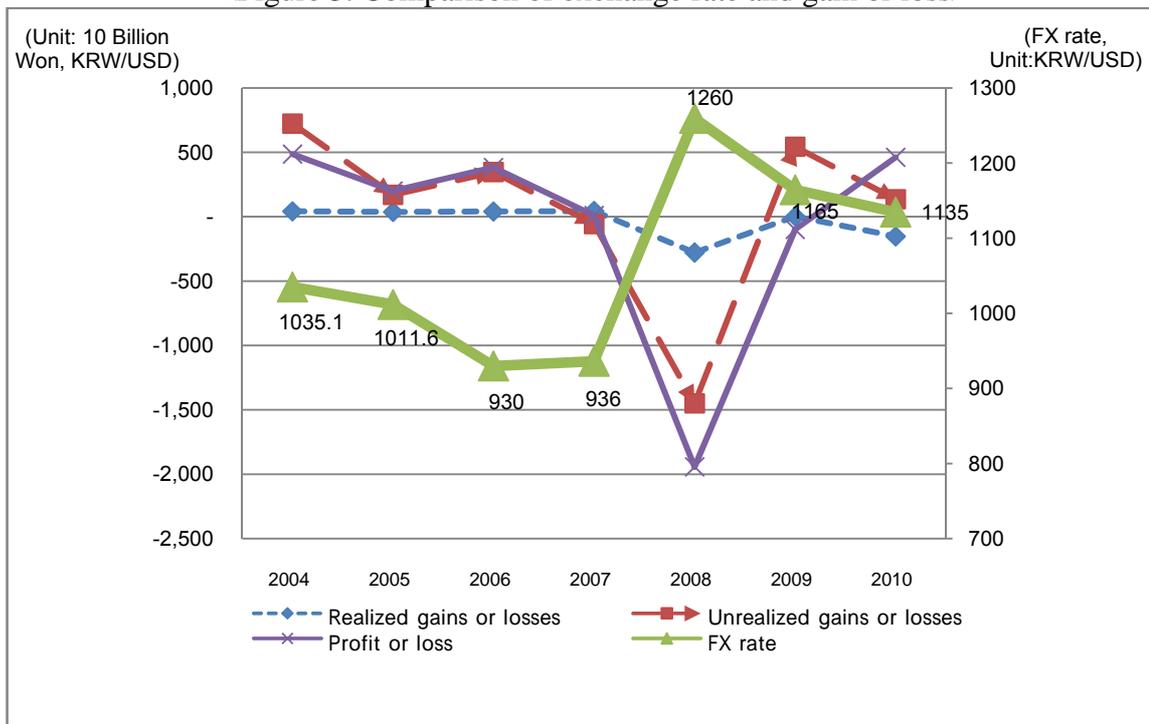
“financial crisis” of 2008 may arise in the near future. Under such a “financial crisis” circumstance, the demand for amendment of “foreign currency accounting” from emerging economies is likely to intensify. Thus, the issue of “foreign currency accounting” should be addressed before such intensification arises.

Consequences

2.11 If the closing rate is applied to foreign currency monetary assets and liabilities in accordance with IAS 21, the result may not show the true financial position and performance of the entity. The data of Company A (2004~2010) in the figure below shows that unrealised foreign currency related losses in 2008 was significantly large while realized losses were relatively stable throughout the rest of the period (Figure 3). This indicates that the unrealised losses during the Financial Crises were temporary and some portion of the unrealised losses did not lead to realised loss afterwards.

2.12 The Company A case demonstrates that translating long-term foreign currency items at the closing rate that fluctuated in an unusual manner due to a short-term event of financial crises does not show the financial position and performance of the entity in an appropriate manner. Furthermore, users of such financial statements would not be able to make rational economic decisions.

<Figure 3. Comparison of exchange rate and gain or loss>¹¹



¹¹ Realised Gains or Losses are obtained by subtracting Loss on Foreign Currency Transaction and Loss on Derivatives from the sum of Gain on Foreign Currency Transaction and Gain on Derivatives Transaction

Unrealised Gains or Losses are obtained by subtracting Loss on Foreign Currency Translation and Loss Due to Decline in Value of Derivatives from the sum of Gain on Foreign Currency Translation and Gain Due to Increase in Value of Derivatives

Criterion 2: Existing guidance available

- 2.13 Criterion 2 considers whether the project will address an area on which the existing guidance is insufficient.
- 2.14 While IAS 21 requires foreign currency monetary items to be translated at the “closing rate” and the resulting translation gain or loss to be reflected in profit or loss for the period, it does not consider any exceptions.
- 2.15 However, if the proposal in this report is followed (refer to Availability of alternative solutions in Criterion 3), a rate other than the closing rate would have to be used when unusual events such as financial crises occur in a market in which the “closing rate” cannot reflect the best estimate of the future events, e.g., a thin market.
- 2.16 Therefore, guidance should be provided regarding the characteristics of the market in which the “closing rate” cannot reflect the best estimate of the future events; conditions for unusual events such as financial crises; and the method to calculate an alternative rate that can replace the “closing rate”.

Criterion 3: The possibility of increasing convergence

- 2.17 The proposal would neither enhance nor undermine convergence. It will not result in increasing convergence because accounting standards in most nations, including U.S. GAAP, are significantly the same regarding the accounting for translation of foreign currency monetary items at the closing rate. At the same time, it will not adversely affect the convergence between IFRS and US GAAP since US uses a reserve currency (i.e. USD) as its functional currency.

Criterion 4: The Quality of the IFRSs to be developed

- 2.18 Criterion 4 considers the qualitative aspects of the standards that are proposed to be developed. This criterion considers the following factors:
- (a) availability of alternative solutions
 - (b) cost/benefit considerations
 - (c) feasibility

Availability of alternative solutions

- 2.19 As described in Criterion 1, the most efficient way for the IASB to address the issues raised by emerging economies is to first examine whether a different accounting treatment is needed for foreign currency monetary items in times of “financial crises” and if so what alternatives are available.
- 2.20 Our proposal, in short, is that another exchange rate rather than the closing exchange rate should be permitted to be used when the closing exchange rate is unable to reflect the best estimate for future events in unusual circumstances such as the “financial crises”. The basis and details of this proposal are provided in the following paragraphs.
- 2.21 IAS 21 defines the “closing rate” as the “spot exchange rate at the ends of reporting

periods”. Then what is the meaning of translating at the “spot exchange rate”? Regarding this issue, explanations in a BC paragraph on value in use estimated in foreign currency in IAS 36 may be referred to. Paragraph BCZ47 in IAS 36 explains this issue as below.

If a currency is freely convertible and traded in an active market, the spot rate reflects the market’s best estimate of future events that will affect that currency. Therefore, the only available unbiased estimate of a future exchange rate is the current spot rate, adjusted by the difference in expected future rates of general inflation in the two countries to which the currencies belong.

- 2.22 The reason for translating foreign currency monetary items at the spot rate at the ends of reporting periods may be explained as that the spot rate reflects the best estimate of the rate at the time of future settlement of the foreign currency monetary items¹². What should be additionally considered at this point, however, is when unusual events such as the “financial crises” arise. There are doubts as to viewing the spot rate which fluctuated significantly during such an unusual event as the best estimate of the exchange rate at the time of future settlement.
- 2.23 Admittedly, when “a currency is freely convertible and traded in an active market,” it would be rational to regard the spot rate as the best estimate of the exchange rate at the time of future settlement even if events of a “financial crisis” occur. This may be so because such a market would be an efficient market and thus the impact of a single event of “financial crisis” on rate fluctuation would be relatively small. However, when “a currency is not freely convertible and not traded in an active market,” the impact of a single event of “financial crisis” on rate fluctuation would be relatively large and thus the spot rate may not reflect the market’s best estimate at the time of future settlement.
- 2.24 IAS 36 requires that the spot rate be used even when the spot rate does not reflect the market’s best estimate of future events because entities are less likely to make a more reliable estimate of future exchange rates than the current spot rate¹³.
- 2.25 However, the IASB does not seem to have considered the unusual cases of “financial crises” when they reached this conclusion¹⁴. Thus, considering the “financial crises” situations, review should be carried out regarding whether another rate can provide a more reliable estimate when the spot rate is unable to reflect the market’s best estimate

¹² Consider monetary items measured at amortised cost. In the paragraph 6 of the IASB Exposure Draft of ‘Financial Instruments: Amortised Cost and Impairment’ published in November 2009, amortised cost is the present value calculated using the expected cash flows over the remaining life of the financial instrument and the effective interest rate as the discount rate. So, if the expected cash flows are in foreign currency, applying the estimated exchange rate to corresponding cash flows will result in the most accurate translated amount. However, the spot exchange rate is used because of the complexity and reliability of obtaining such estimated exchange rate.

¹³ BCZ50 Even if a currency is not freely convertible or is not traded in an active market—with the consequence that it can no longer be assumed that the spot exchange rate reflects the market’s best estimate of future events that will affect that currency—IAS 36 indicates that an enterprise uses the spot exchange rate at the balance sheet date to translate value in use estimated in a foreign currency. This is because IASC believed that it is unlikely that an enterprise can make a more reliable estimate of future exchange rates than the current spot exchange rate.

¹⁴ As IAS 36 was issued in 1998, the Basis for Conclusion was made by the IASC.

of future events.

- 2.26 Meanwhile, it should be noted that the subject to which alternative rate would be applied is limited to long-term items rather than entire foreign currency monetary items including short-term items. Since unusual circumstances such as the “financial crises” require a certain period of time before being resolved, it would be rational to apply the closing rate for short-term items without exception.
- 2.27 While there should also be discussion about how to distinguish between short-term and long-term items, making this distinction consistent with that specified in IAS 1 for financial statement presentation would be the most reasonable method to enhance consistency and reduce complexity across the standards.
- 2.28 The proposal in short is that there is a need to review alternative rates to replace the closing rate (i.e. spot rate) when the closing rate is unable to reflect the market’s best estimate in unusual circumstances of “financial crises”. Furthermore, the subject to which the alternative rates are to be applied is long-term foreign currency monetary items. This is summarized in Table 1 below.

<Table 1: Areas requiring review in IAS 21>

	Market where the closing rate (i.e. spot rate) represents the best estimate of future events (e.g. deep market)	Market where the closing rate (i.e. spot rate) does not represent the best estimate of future events (e.g. thin market)
Unusual situations such as the “financial crises”	Maintain IAS 21	Review required (Long-term items)
Usual situations	Maintain IAS 21	Maintain IAS 21

- 2.29 In carrying out the review required as above, the following should be examined to provide possible alternatives.
- Step 1: Define the market where the closing rate is unable to reflect the market’s best estimate of future events
 - Step 2: Determine unusual circumstances such as the “financial crises”
 - Step 3: Determine alternative exchange rates which can replace the closing rate

Step 1: Define the market where the closing rate is unable to reflect the market’s best estimate of future events

- 2.30 IAS 36 refers to a case where “a currency is not freely convertible and not traded in an active market” as an example of when “the spot rate cannot reflect the market’s best estimate of future events.” Therefore, the definition of “active market” in IFRS should be examined first. “Active market” is defined in IAS 39 as below.

A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group,

pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

- 2.31 According to the definition, the foreign exchange market of a country that adopted the floating exchange rate system would generally fall into the category of "active market" by definition. The question, however, is that whether the case where the spot rate is unable to reflect the market's best estimate of future events would arise only when the currency is not traded in an "active market" in accordance with the definition in IAS 39.
- 2.32 IAS 19 may be referred to regarding this issue. IAS 19 requires the return of corporate bonds to be used as the discount rate for discounting post-employment benefit payables when the corporate bond market is a deep market. An assumption is likely to be inherent in this requirement that the return of corporate bonds in a market that is not deep is unable to reflect the best estimate of the liability at the time of settling post-employment benefit payables in the future.
- 2.33 Thus, by analogy, the concept of "deep market" in IAS 19 could be used to the foreign exchange market¹⁵. "Thin market," as opposed to "deep market," is defined in a number of papers on the microstructure of foreign exchange market, and these papers analyse the movement of the exchange rates in thin markets based on the properties of thin market. "Thin market" is described in several papers as cited in the following paragraphs.
- 2.34 One report¹⁶ utilizes the "turnover of foreign exchange market activity compared to GDP" as an indicator for the "thin market". This report analyses the nations heavily affected by the Asian Financial Crisis in 1997, e.g., Indonesia, Thailand, Malaysia, and Korea, and cites their foreign exchange markets having been "thin markets" as the main reason for their failure to stop the herding behavior of investors which led to the skyrocketing foreign exchange rates¹⁷.
- 2.35 Another way to define a "thin market" includes using the number and characteristics of market participants. For example, if there are limits as to market participants and the role of government is significant among the market participants, it is analysed that the foreign exchange market would not be deep and competitive. Furthermore, in such thin

¹⁵ Some may question whether it is plausible to divide foreign exchange markets into "deep market" and "thin market", arguing that all foreign currency transactions are executed on a global level; that is, there is only one global active and deep foreign exchange market.

Such argument, however, would be legitimate under an ideal situation. But most currencies other than key reserve currencies are not actively traded offshore and jurisdictions play a role in managing the inflows and outflows of their currencies and controlling their onshore markets through regulations and policies, etc.

Thus it can be said that it is feasible to divide foreign exchange markets into "deep market" and "thin market". Also the "thin market" would be premised on the condition that the currency is not a key reserve currency and transactions in that currency are executed mostly onshore.

¹⁶ Min, H.G. and Judith A. McDonald, "Does a thin foreign-exchange market lead to destabilizing capital-market speculations in the Asian crisis countries?", working paper no. WPS 2056, World Bank

¹⁷ In terms of turnover of foreign exchange market activity over GDP, the four countries in the analysis was 1.0 on average, compared to 8.23 for five advanced countries.

market, the volatility would increase if the floating foreign exchange rate system is implemented¹⁸.

- 2.36 These studies indicate that when foreign exchange markets display the characteristics of “thin market,” the spot rate in such markets may not represent the best estimate of future events.
- 2.37 Furthermore, it should be noted that the micro-structural analysis of “thin market” can effectively explain a short-term situation like the “financial crises”. The micro-structural factor of market can adequately explain the movement of exchange rates in the short term while other theories of foreign exchange rate movement like macroeconomic fundamentals or random walk model are less likely to do so¹⁹.
- 2.38 The foreign currency accounting project should utilize the studies in the field of economics on the microstructure of the foreign exchange markets and develop concrete bases for identifying what constitutes a “thin market” in the future.

Step 2: Determine unusual circumstances such as the “financial crises”

- 2.39 Other IFRS standards may provide a foundation for prescribing unusual circumstances.

2008 amendment to IAS 39

- 2.40 It may be helpful to first consider the IASB’s 2008 amendment to IAS 39 for reclassification of financial instruments. As described above, in that amendment, the IASB implicitly referred to a situation like the “financial crisis” as “rare circumstance” and “a single event that is unusual and highly unlikely to recur in the near term” when they amended IAS 39 to permit an item measured at fair value to be measured at amortised cost in 2008.
- 2.41 However, it would not be adequate to define unusual circumstances for foreign currency accounting in the same way as the 2008 amendment. It is our view that the description in the 2008 amendment is too broad to serve as indicators by which an entity assesses whether an unusual circumstance has occurred in the foreign currency market.

IFRS 13, Fair Value Measurement

- 2.42 It appears that IFRS 13, *Fair Value Measurement* can provide a more solid groundwork for determining unusual circumstances. The following two aspects of IFRS 13 need to be noted in determining unusual circumstances: i) concrete indicators, and ii) rigorous assessment. First, IFRS 13 sets out a number of concrete indicators by which an entity can determine whether significant adjustment (Level 2 or Level 3 measurement) should be made to quoted prices (Level 1 measurement). Second, IFRS 13 is rigorous in that it first requires an entity to determine whether there has been a significant decrease in the

¹⁸ Mirza Azizul Islam, “Exchange rate policy of Bangladesh – not floating does not mean sinking”, Asia-Pacific Development Journal, Vol 9, No. 2, December 2002, United Nations

¹⁹ Jorge Canales-Kriljenko and Karl Habermeier, “Structural factors affecting exchange rate volatility: A cross-section study”, IMF Working Paper, August 2004, International Monetary Fund

volume or level of activity for the asset or liability and, if that is the case, as a second step, the entity is required to assess whether a transaction is not orderly. Only then Level 2 or Level 3 measurement can be used.

- 2.43 Not much effort has been made to develop potential indicators as yet, but it would be reasonable to base the discussion over this matter upon the same concreteness and rigor as required in IFRS 13.
- 2.44 Meanwhile, some may raise a concern about determining when unusual circumstances disappear and the markets become normal again because once it is reversed, it is necessary to re-use the closing rate instead of the alternative rate, from the point of time when the unusual circumstances cease to exist.
- 2.45 The concern, however, may not lead to a critical issue if concrete and clear indicators are provided for determining when unusual circumstances begin. This is because it would be sufficient to resolve such concern by prescribing a requirement such that reverse changes in indications for the occurrence of unusual circumstances shall mark the end of unusual circumstances. Such requirement will then make it unnecessary to consider separate indicators for determining when unusual circumstances disappear. This logic is also consistent with the way in which IAS 36 provides indicators for reversal of impairment loss; IAS 36 prescribes the cases that indicate reversal of impairment loss by mirroring the cases that indicate incurrence of impairment loss.²⁰
- 2.46 Some others may point out another issue related to the end of unusual circumstances; that is, when an unusual circumstance ceases to exist, how an entity should account for cumulative exchange difference between the amounts resulting from translating at an alternative rate and the amounts that would otherwise have been resulted from translating at the closing rate during the period of unusual circumstances.
- 2.47 However, according to our proposal, there should not be any such cumulative exchange difference. Only change that would be brought in by our proposal is that an alternative rate replaces the closing rate during the period of unusual circumstances. In other words, the exchange difference resulting from translating at the alternative rate will be recognised in profit or loss as well. Therefore, even when unusual circumstances turn normal again, there will be no need to consider any exchange difference in a different manner for that period.

Step 3: Determine alternative exchange rates which can replace the closing rate

- 2.48 If it is determined after Step 1 and 2 that a market exists in which the closing rate is unable to reflect the best estimate of future events in an unusual situation, e.g., “financial crises,” then the next step should include examining whether it is possible to provide an alternative exchange rate that is more relevant and reliable than the closing rate. The following two alternatives are proposed herein.

Alternative 1: Adjusted historical rate model

²⁰ Paragraph 112 of IAS 36 states:
Indications of a potential decrease in an impairment loss in paragraph 111 mainly mirror the indications of a potential impairment loss in paragraph 12.

- 2.49 The first alternative is to utilize the long-term trend rate calculated by using historical rate data when an event like the “financial crisis” arises. For example, a historical rate adjusted by the long-term trend line may be used or a moving average rate may be used.
- 2.50 Reliability of this alternative would be relatively high compared to the alternative 2 below because it is based on objective data. Moreover, this alternative would be able to reflect better estimate of future events than the spot rate in times of “financial crises” since long-term items reflect the long-term trend line of exchange rates.

Alternative 2: Expected rate model

- 2.51 The alternative 2 is to use the expected exchange rate that reflects the best estimate at the time of settlement of long-term monetary items. One example would be to calculate an expected rate on each item by extending the long-term trend line of exchange rate to the expected settlement date. Another example would be to calculate an econometrically forecasted rate at the balance sheet date by using macroeconomic variables. The expected rate model should be reviewed in detail from the economic point of view regarding how to calculate the expected rate and also whether such expected rate may be a more rational alternative than the closing rate.
- 2.52 The alternative 1 may be more reliable since it uses past rate data but its relevance as a future estimate may be weak. Therefore, if the expected rate, excluding the rate fluctuations caused by the effect of the “financial crises,” can be estimated with reliability, then the second alternative may be more appropriate than the alternative 1 above.
- 2.53 This alternative using an expected rate would also be adequate in the context of the IASB’s current direction for amendment of financial instrument impairment in IAS 39. Although the existing IAS 39 specifies to recognize an impairment loss when an impairment event arises (“incurred loss model”), the current direction for amendment is to recognize an impairment loss based on expected future cash flows (“expected loss model”). Thus, using the closing rate and using the expected rate may be likened to the “incurred loss model” and the “expected loss model”, respectively. Using the closing rate is akin to the “incurred loss model” in that it considers an event that have already occurred, and using the expected rate is analogous to the “expected loss model” in that it considers expected future cash flows at the time of settlement of long-term items. .

Criticisms over the alternatives

- 2.54 There may be criticisms against the alternatives provided herein. Proponents of the criticisms argue that even if an event like the “financial crisis” arises in a “thin market,” there would be no better estimate than the closing rate if the closing rate reflects recent transactions in the foreign exchange market.
- 2.55 We believe, however, such criticisms are defective in that they regard the concept of best estimate the same as the concept of fair value. These two concepts are conceptually different from each other. The criticisms would be valid if the purpose of translation is to measure fair value. In other words, from the perspective of fair value measurement, an item should be measured at a price reasonably exchangeable between the parties on

the date of measurement. In that context, if the closing rate results from recent transactions of the foreign exchange market, it would be valid to translate at the closing rate even when an event like the “financial crisis” arises in a “thin market.” However, the above criticisms would not be reasonable if the purpose of translation is to reflect the best estimate of the future rate as suggested in this report. For long-term items, it would be difficult to view the closing rate as the best estimate of future rate if the portion of the closing rate that have suddenly fluctuated in the short term during the “financial crisis” due to the nature of the “thin market” is not eliminated.

- 2.56 Further study should be carried out to determine whether the above described alternatives can indeed provide better estimates than the closing rate and also to develop even better alternatives. However, such limitations would not be able to justify the argument that the closing rate should continue to be used in all circumstances.

Cost/benefit considerations

- 2.57 At this stage, it would be difficult to accurately compare the costs and benefits of this alternative since the alternative requires further development. However, the benefits would be greater than the costs if the rate replacing the spot rate is able to show the economic substance in a clearer manner.

Feasibility

- 2.58 We believe that the IASB will be able to reach a conclusion within a reasonable time frame regarding the definition of the “thin market” described in this report, that is, a market in which the closing rate is unable to reflect the best estimate of future events of the market. Since the economic study on the “thin market” characteristics in foreign exchange markets and the effect of thin markets on rate fluctuations has already been carried out, the IASB can handily review the issue by forming a working group comprised of relevant experts.

Criterion 5: Resource constraints

- 2.59 Criterion 5 considers whether there are sufficient resources to undertake the project. The criterion considers the following factors:
- (a) availability of expertise outside the IASB
 - (b) amount of additional research required
 - (c) availability of resources
- 2.60 Foreign currency accounting has been frequently discussed in advanced countries in the past and thus there should be a large number of experts available outside the IASB. Furthermore, the foreign currency accounting working group made up of NSSs should be able to provide the resources necessary when the IASB carries out the project.