# Notes for 2nd Emerging Economies Group (EEG) meeting

**Venue:** Desire Hall, Le Merdien, New Delhi, India
**Date:** December 19~20, 2011
**Participants:** Ian Mackintosh (Vice Chair, IASB)
Prabhakar Kalavacherla (Board Member, IASB)
Wayne Upton (Director of International Activities, IASB; Chairman, IFRS Interpretation Committee)
Nelson Carvalho (Brazil)
Carl Douglas (Brazil)
Yang Min (China)
Ouyang Zongshu (China)
Lu Jianqiao (China)
Chen Yu (China)
Ganapathy Ramaswamy (India)
Manoj Fadnis (India)
Jaydeep Shah (India)
Rosita Uli Sinaga (Indonesia)
Suk-Sig (Steve) Lim (Korea)
Jong-Soo Han (Korea)
Won-Hee Han (Korea)
Hyun-Sun Hong (Korea)
Bee Leng Tan (Malaysia)
Igor Sukharev(Russia)
Galina Ryltsova (Russia)
Sue Ludolph (South Africa)
Kim Bromfield (South Africa)

## Topic Discussed on Day 1: Foreign Currency Accounting

### 1. Understanding why foreign currency accounting is an issue

1.1 The Korea Accounting Standards Board prepared a comprehensive research report on foreign currency accounting and the practical problems caused by implementing IAS 21 *The Effects of Changes in Foreign Exchange Rates*, in times of financial crisis.

1.2 Wayne Upton and the IASB staff prepared two papers on the same issue, one of which provided the basis for discussion on the project scope. As the IASB were in the process of undertaking an agenda consultation, the IASB would consider the EEG's inputs in determining whether foreign currency could be a potential future agenda project.

1.3 Korea argued that the requirement to use the closing rate for translation of long term monetary items needs review, since the closing rate may not reflect the economic substance of an entity under some circumstances. Korea suggested the following:

- When a foreign currency market is a thin market and rare circumstances, such as a financial crisis takes place, the closing rate did not represent the best estimate of the future exchange rates.

- If the closing rate did not represent the best estimate of the future exchange rates, it was necessary to consider requiring or permitting the use of an alternative rate.

1.4 India pointed out that using the closing rate for translation of long-term monetary items caused unnecessary income statement volatility.

1.5 China consented to raising this as an issue as volatility would not be mitigated if long term monetary items were translated at the closing rate.

1.6 Brazil voiced a concern that using a rate other than the closing rate would not portray the status at the reporting date and asked participants to explain what the real problems were.

1.7 Korea gave an example of the 1997 Asian Financial Crisis:
When the financial crisis occurred, the Korean government and the IMF used debt to equity ratios as an indicator to determine which companies should undergo restructuring. As foreign exchange rates rose sharply during that period, so did the debt to equity ratios of many Korean banks which had incurred long-term foreign currency borrowings. As a result, many of those banks went bankrupt.

**2. Discussing the scope of a possible amendment**

2.1 Wayne Upton invited participants to discuss the scope of amendment if the IASB were to take foreign currency accounting onto its agenda. The options considered were a comprehensive review of IAS 21 (View 1), a targeted review for improvement on specific issues (View 2), or a narrow-scope review for minor, operational issues (View 3).

2.2 The results of the discussions and support for the different views were as follows:

2.2.1 View 1 – a comprehensive review of IAS 21 was supported by Korea, China and India. Brazil agreed that IAS 21 required a review and therefore supported this view for a long-term research project.

2.2.2 View 2 – a targeted review focusing on the translation of long-term monetary items was supported by China, Malaysia, Indonesia and Korea. Russia preferred view 3, but indicated it would support this view for a long-term project of the IASB.

2.2.3 View 3 – a narrow scope review focusing on implementation issues of the translation of long-term monetary items was supported by Brazil, Russia and South Africa.

2.3 India explained the problem of a natural hedge, and Wayne Upton indicated that addressing the natural hedge issue would require a comprehensive review of IAS 21.

**3. Considering the criteria set out in IASB's Due Process Handbook**

3.1 Wayne Upton said that in order for foreign currency accounting to be considered by the IASB as a potential future project, it should satisfy the criteria stated in IASB Due Process Handbook for agenda proposals. Not all the criteria were discussed.

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

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; and
- Consequences of not adding the project to the agenda.

3.2 China made two points in terms of relevance; that financial statements should be able to forecast future cash flows of an entity and financial statements should reflect an entity's performance. In this regard, China argued that using the closing rate for the translation of long-term monetary items was not appropriate because 'future' cash flows were being translated at the 'current' exchange rates. This caused a mismatch. In terms of risk, long-term monetary items did not contain much risk resulting from short-term volatility caused by translation at the closing rate. Therefore using the closing rate for long-term monetary items would not encapsulate risk appropriately in their view. China also suggested that the foreign currency accounting issues should be addressed with the review of the appropriateness of using the closing rate for items like long-term monetary items, rather than overemphasizing the fact that the closing rate might not be appropriate in a thin market and rare circumstances.

3.3 Many countries supported additional disclosure requirements describing the impact on the financial statements of whatever rate was used to translate long-term monetary items, as this would be beneficial to users to understand the effect on key ratios.

3.4 Prabhakar Kalavacherla ('PK') asked whether members had observed companies leveraging structuring opportunities in order to evade booking transaction gains or losses in profit or loss and instead recognise these in Other Comprehensive Income (OCI).

3.5 Brazil responded that there were many structuring deals in Brazil for establishing foreign operations, but it was not out of the concept of 'accounting drives business' incentives, but rather for hedging incentives.

3.6 Korea mentioned that as this project is a matter of 'urgency' for many EEG countries, it could be considered by the IASB as part of the financial crisis project.

**Criterion 4: The Quality of the IFRSs to be developed**

3.7 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; and
- feasibility.

***Alternative rate***

3.8 Korea argued that foreign exchange rates should reflect economic fundamentals between two countries in the long run. For example, purchasing power parity (PPP) should hold in the long run. In this sense, if a foreign exchange rate fluctuated without any change in economic fundamentals in the two countries, the rate must converge to a level reflecting PPP. Therefore, an alternative rate, based on an economic model, should be considered for the translation of long-term monetary items.

3.9 Ian Mackintosh expressed doubt that foreign exchange rates converge to a level based on economic theory, even in the long-term. In his view, theoretical rates seem to hold true only in theory.

3.10 Wayne Upton asked if forward exchange rates could be considered as an alternative.

3.11 China commented that it's very important to ensure that the alternative rate is reliable and objective. If forward rates for certain periods were available, using forward rates would be more appropriate.

3.12 India remarked that it would not be possible for them to use forward exchange rates since there is no deep forward exchange rate market. It also mentioned that using forward rates would not be an appropriate alternative in general, because forward rates were only available for short-term periods, for instance, a 6-month period.

3.13 Brazil expressed a concern that financial statements would not provide current information at the reporting date if forward exchange rates were used, since they represent future expectations.

3.14 South Africa pointed out that forward exchange rates comprised of the spot exchange rate and a forward premium and therefore was a function of the spot rate. South Africa also mentioned that although forward exchange rates may be used as an option, the fact that forward exchange rates were only available for 2~3 year terms would make it difficult to apply this forward rate to longer-term monetary items with a 5-year maturity.

3.15 Russia was opposed to using forward exchange rates.

3.16 Korea expressed a view that forward exchange rate may be used as an alternative if the portion of interest rate component could be taken out. Then the forward exchange rate excluding the interest rate component would be very close to future exchange rates.

3.17 Wayne Upton questioned whether using forward exchange rates would in effect solve the problems companies were experiencing; for example, income statement volatility could become worse by using forward exchange rates.

3.18 Korea responded that whether financial statements would look better or worse should not be a matter of concern as what mattered was whether forward exchange rates would better reflect the economic substance of the translation.

3.19 PK made a comment that it would be necessary to think about what indicators would determine whether forward exchange rates represented the economic substance better than the closing rate.

***Other Comprehensive Income***

3.20 China raised the issue that recognising exchange differences in OCI as a potential alternative to recognising exchange differences in profit and loss might reduce income statement volatility. However, the underlying principle of using OCI needed to be addressed by the IASB first. Russia argued that presenting exchange differences in OCI would not solve the problem.

3.21 Most countries agreed with these views that the principles of OCI need to be first established.

***Deferral and amortisation***

3.22 India alluded to the fact that it permitted companies to defer and amortise exchange differences using a reserve account, arguing that such method showed the economic substance more appropriately for long-term monetary items.

3.23 PK noted that one of the practical disadvantages of using the amortisation method was that it could leave a large unamortised balance at maturity. He cited Australia's past experience in this area.

## 4. Addressing other issues

4.1 Wayne Upton raised other relevant foreign currency accounting issues, such as the difficulty in determining a functional currency, foreign currency convertible debt, etc.

4.2 Russia, South Africa, Indonesia commented on the difficulty in determining a functional currency in many instances. Examples provided were:

- At subsidiary A, sales were in USD, costs were in the local currency (LC). The holding company was in a different jurisdiction and had a different LC from that of subsidiary A. The holding company was an extension of subsidiary A. The IFRIC decision in this area did not help to determine the functional currency of the holding company.

- Where you have an investment holding company of a mining or oil and gas operation. The local laws where the mining or oil and gas operation is based often require the LC to be the functional currency.

4.3 India noted that as foreign currency convertible debt was a significant issue for them, they suggested that the IASB consider a review of IAS 32 – *Financial Instruments-Presentation* in this respect.

4.4 At the request of Wayne Upton, Korea gave a short presentation on the linked presentation method with regard to hedge accounting.

## 5. Action points

5.1 Wayne Upton would feedback outcomes from the EEG discussions to the IASB staff who were preparing the agenda consultation papers for the IASB.

5.2 All participants were requested to review Appendix 3 – A Research Report on Foreign Currency Accounting, and communicate with the IFRIC staff if they had any practical implementation issues on any areas mentioned, or not, therein.

## Topics discussed on Day 2: Land interests, IFRIC 12 and IFRIC 15

### 1. Land interests

1.1 Indonesia prepared a paper and gave a presentation regarding the accounting treatment for land in Indonesia. They provided the fact pattern for the two most common types of land rights in Indonesia. In essence, they argued that long-term leases of land should be allowed to be treated as an in-substance purchase or sale. They raised this issue due to the fact that there were multiple interpretations among Indonesian reporting entities and the 'big four' audit firms. They wished to determine if any of the other EEG countries had a similar problem.

1.2 The different interpretations among IFRS-based entities were noted as follows:

1.2.1 Land is recognised as a purchase of property, plant and equipment (PPE) and the cost is not depreciated.

1.2.2 The purchase of land is recognised as a finance lease and the cost of land subject to depreciation over the life of the land right. The support of this argument is that the State, through the Indonesia National Land Agency, still have the final discretion on the extension of the land right, thus, the useful life of land is arguably limited.

1.2.3 The purchase of land is recognised as the purchase of an indefinite life intangible asset, and is not amortised. The argument, based on the actual asset being purchased, is the right to use of land and not the physical land itself. Thus, an intangible asset classification is more appropriate.

1.2.4 The land is recognised as an operating lease. The initial payment was recognised as a deferred payment. The argument is based on that the term of land right given by the Government is a lot shorter than the economic useful life of the land. Although it can be renewed and extended indefinitely and there has been no rejection from the Government to the renewal and extension submissions, there is always inherent risk that the Government may deny the submission.

1.3 Due to the multi interpretations issue, the Indonesian Accounting Standards Board has issued an interpretation for local statutory financial statements to clarify that those types of land rights in Indonesia should be treated as non-depreciable PPE. It has resolved the issue for local statutory financial reporting but not for certain entities which is required to prepare full IFRS Financial Statement for various reasons.

1.4 EEG members generally supported submission of this issue to the IFRS Interpretations Committee for its consideration.

### 2. IFRIC 12 *Service Concession Arrangements*

2.1 Brazil gave a presentation and provided background documents in the form of IFRS Interpretations Committee staff papers on issues regarding proposed amendments to IFRIC

12. The issue raised was regarding payments which the operator was required to make to the grantor for the service concession (concession fees).

2.2 A submission had already been made to the IASB staff, who had concluded that it is necessary to amend IFRIC 12 to clarify payments from the operator (concessionaire) to the grantor. The scope of the staff's recommendation was to address fixed payments only.

2.3 Brazil's concern was that the variable component of payments, indexed by inflation, should be fully recorded as a 'one hit' expense of the period in the income statement, even though the payments were required during the concession term and they were fully linked with positive adjustments of the right to charge infrastructure users.

2.4 No decisions were reached, as it was noted that this issue would be discussed at the next IFRS Interpretations Committee meeting, on January 17th and 18th, 2012.

**3. IFRIC 15 *Agreements for the Construction of Real Estate***

3.1 The discussion on this IFRIC centred around the diversity in applying the concept of 'continuous transfer of a good', as expressed in paragraph 17 of IFRIC 15.

3.2 There was majority agreement of the countries present to request the IASB to withdraw this IFRIC as it was causing more implementation issues in practice, than if it were not in existence.

3.3 All countries were asked to consider the impact in their country if this interpretation was withdrawn by the IASB.

**4. Administrative Issues**

4.1 The Communiqué for the meeting was discussed and agreed by all the participants.

4.2 It was agreed that notes of the meeting should be drafted and Korea offered to do this and South Africa to review the first draft. Thereafter they would be sent to Wayne Upton for his review before sending out to all present for their edits.

4.3 Planning for the 2012 EEG meetings was discussed. It was agreed that these would take place in the EEG countries and if possible linked to an NSS or WSS meeting to make the travel worthwhile. PK suggested considering relevant presentations by preparers or users on the topics selected. These would be determined and communicated by Wayne Upton and Yu Chen.

4.4 It was agreed that all countries would consider possible future meeting topics and these should be communicated to Wayne Upton.