

STAFF PAPER

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Project	Foreign Currency Translation		
Paper topic	Proposal for a comprehensive review		
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Introduction

1. In December 2011, the IASB received an agenda proposal from the Korea Accounting Standards Board (KASB) for a narrow scope amendment to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, as discussed in Agenda Paper 8A(a). As an appendix to this proposal, the KASB also included a request for a more comprehensive review to IAS 21 in a Research Report. This Research Report was prepared with the objective of providing a foundation for carrying out the basic research for a comprehensive review and is based on the results of an international Working Group established by the KASB in 2010. The Working Group consisted of representatives from Australia, Brazil, Canada, India, Korea and South Africa.
2. In addition, in the KASB's response to the Discussion Paper *A Review of the Conceptual Framework*, which was published in 2013, it included a Supplementary Document 'Discussion on the nature of foreign currency translation in terms of measurement on the level of Conceptual Framework'. This Supplementary Document further explores and develops some of the issues raised in the earlier Research Report.
3. In this paper, we:
 - (a) summarise the issues raised in the KASB's two papers;
 - (b) review the outreach that has been conducted to date; and

- (c) perform an initial assessment of the KASB's proposal.

KASB's Research Report and Supplementary Document

- 4. In this section, we outline the KASB's proposal for a comprehensive project on IAS 21 as set out in its papers, as follows:
 - (a) the need for a comprehensive review;
 - (b) the scope of the KASB's work;
 - (c) key issues raised in the KASB's Research Report; and
 - (d) a summary of the KASB's Supplementary Document.

Need for a comprehensive review

- 5. The KASB argues that a comprehensive review of IAS 21 is needed to clarify the conceptual basis for the translation requirements in IAS 21 to:
 - (a) help resolve/address the concerns and conflicting views discussed in Agenda Paper 8A(a) (ie that current requirements in IAS 21 might not reflect the true economic substance of long-term foreign currency transactions when there are significant foreign exchange fluctuations caused by global economic crises in a thin market); and
 - (b) provide a basis for reviewing the relevance of possible accounting alternatives in the future (for example the use of other comprehensive income (OCI) or profit or loss for foreign exchange gains or losses), given the current lack of rationale for the requirements in IAS 21.

Scope of the KASB's work

- 6. The KASB's two papers primarily focus on the translation of foreign currency transactions into the entity's functional currency in its separate financial statements.

This is on the basis that most of the issues directly raised by stakeholders were related to this aspect of IAS 21.

7. The papers do not make any conclusions. Instead they explore some different alternatives and make some observations and suggestions, drawing on equivalent US GAAP Standards and academic literature.

Key messages from the Research Report

8. The KASB's Research Report covers several topics. A fuller summary provided by the KASB is given in Appendix B of Agenda Paper 8A(d). The key messages are:
 - (a) *objective*: IAS 21 has no clear objective or Basis for Conclusions, so it is difficult to understand the principles behind the requirements in IAS 21.
 - (b) *measurement*: There is a need to understand and define how foreign currency translations interrelate with the measurement basis for elements in the *Conceptual Framework*.
 - (c) *the monetary/non-monetary distinction*: the KASB suggests that the theoretical basis for distinguishing between monetary and non-monetary items should be clarified. In addition, the Research Report points out that the distinction between monetary and non-monetary items can be ambiguous when an item has both monetary and non-monetary characteristics.
 - (d) *recognition of foreign exchange gains or losses*: there should be an explicit conceptual basis that underpins the treatment of foreign exchange gains and losses. It is not clear from IAS 21 why foreign exchange gains and losses on translating monetary items are recognised immediately in profit or loss, nor why foreign exchange gains and losses on the translation of net investment on consolidation are recognised in OCI.
9. Other secondary issues raised in the Research Report include:

- (a) *definition of foreign operation*: the IAS 21 definition of a foreign operation could be construed as referring to separate legal entities only. The KASB proposes that foreign operations should be determined according to their economic substance consistent which would be with the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting –The Reporting Entity*, which was published in 2010.
 - (b) *linked presentation for fair value hedges*: the KASB and the Korea Shipbuilders’ Association assert that using a linked presentation for fair value hedges of long-term ship building contracts in the balance sheet would better reflect the economic substance of an entity’s hedging activity. They point out that grossing up the balance sheet adversely affects an entity’s debt to equity ratio, despite the fact that the hedge is mitigating foreign exchange risk.
10. The Research Report also includes some other specific issues that were raised by the Working Group. These are summarised and addressed in Agenda Paper 8A(c).

Supplementary Document

11. Similar to the Research Report, the KASB’s Supplementary Document only deals with the translation of foreign currency denominated transactions in an entity’s separate financial statements. It explores and develops the following three questions further:
- (a) What is the conceptual measurement basis for translating foreign currency transactions after initial recognition?
 - (b) What exchange rate should be used on subsequent reporting given the conceptual measurement basis?
 - (c) Where should foreign exchange differences be recognised?

12. The following table summarises the three different measurement bases explored in the Supplementary Document and the KASB’s suggested implications for the accounting treatment. The KASB’s rationale is given in its Supplementary Document in Appendix C of Agenda Paper 8A(d).

(a) Measurement basis	(b) Exchange rate on subsequent reporting	(c) Recognition of exchange differences
<p>View 1: Translation is a <i>mechanical conversion</i> (ie not a measurement).</p>	<p>Translate all balance sheet items at the closing rate.</p>	<p>Exchange differences should not be recognised in profit or loss.</p>
<p>View 2: Translation is another <i>separate measurement</i> from the underlying measurement basis of the assets or liabilities.</p>	<p>Translate balance sheet items that are exposed to currency risk at the closing rate, in ‘normal circumstances’.</p>	<p>Depends upon the outcome of the <i>Conceptual Framework</i> project</p>
<p>View 3: Translation is part of the <i>same measurement basis</i> as used to measure the asset or liability.</p>	<p>Translate items using the exchange rate that corresponds to the measurement basis in a foreign currency, ie:</p> <ul style="list-style-type: none"> • historical rate for cost-based measurements; • closing rate if the item is measured using current market prices; and • closing rate (in ‘normal circumstances’) for items 	<p>Recognise exchange differences in profit or loss or OCI on the same basis as the gains or losses from measuring the item in the foreign currency are recognised.</p>

	measured using ‘other cash-flow based measurements’.	
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13. The KASB proposes that the measurement basis for dealing with the effects of changes in foreign currency (ie column (a)) should be included in the *Conceptual Framework*, whereas the requirements regarding which exchange rate should be used on subsequent retranslation (column (b)) and where the exchange differences should be recognised (column (c)) should be dealt with in the Standard. However as noted in paragraph 6.5 of the Discussion Paper *A Review of the Conceptual Framework*, the IASB determined that issues associated with the translation of amounts denominated in foreign currency were best dealt with when revising the relevant Standard, instead of in the *Conceptual Framework*. This was subsequently confirmed by the IASB when discussing the scope of the *Conceptual Framework* project in April 2014.
14. The KASB observes that View 3 gives an outcome that is not too dissimilar to that in IAS 21, provided that monetary items measured at amortised cost are viewed as being measured using ‘other cash-flow based measurements’, which is consistent with the IASB’s approach of estimating future cash flows in IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*.

Outreach

15. Limited outreach in respect of a comprehensive review of IAS 21 has been performed to date. The available outreach is:
- (a) responses to the Agenda Consultation Request for Views in 2011; and
 - (b) discussion at the Emerging Economies Group (EEG) meeting in December 2011.

2011 Agenda consultation

16. A summary of the views expressed by those respondents to the 2011 Agenda Consultation Request for Views that commented on Foreign Currency Translation as a possible research project is given in paragraphs 19-21 of Agenda Paper 8A(a).

EEG meeting December 2011

17. At the meeting of the EEG in December 2011, the group discussed the possible scope of a project if the IASB decides to take foreign currency accounting onto its agenda. The preferences expressed by the representatives of the national standard setters at the meeting were as follows:
- (a) two supported a comprehensive review of IAS 21;
 - (b) three expressed a preference for a more targeted review to look at the translation of long-term monetary items; and
 - (c) two preferred a very narrow-scope review to focus on implementation issues.

Staff initial assessment and recommendation

Is a fundamental comprehensive review of the conceptual basis for IAS 21 needed?

18. The KASB papers raise some interesting points. IAS 21 is an older Standard that does not have a Basis for Conclusions. The KASB asserts that this means that it is difficult to understand the conceptual basis for the translation requirement for foreign currency transactions in the Standard and why the translation method in IAS 21 was selected over possible alternatives. They argue that reviewing the conceptual basis for requirements to translate foreign currency items into an entity's functional currency, and making consequential amendments to the Standard could:

- (a) provide a more coherent approach to addressing concerns about the application of the Standard and when considering alternative possible accounting treatments;
 - (b) ensure that the Standard is consistent with the IASB's latest thinking on the *Conceptual Framework*;
 - (c) provide a basis for addressing the various issues that have been raised over time with IAS 21 (for example the issues raised by the KASB Working Group and issues raised to IFRS Interpretations Committee (see Agenda Paper 8A(c)).
19. However, the proposal for a comprehensive review that has been led by the KASB was primarily to address concerns that the current Standard does not faithfully reflect transactions in rare circumstances outlined by the KASB, as discussed in Agenda Paper 8A(a). The staff believes that this issue by itself does not warrant further consideration by the IASB at this point in time and hence it does not by itself drive the need for a comprehensive review of the conceptual basis for IAS 21.
20. Our assessment is that, whilst there might be a few specific exceptions, on the whole IAS 21 is functioning well for the vast majority of foreign exchange transactions and is well understood. This is evidenced in part by the thin spread of issues raised to the IASB over the last 12 years or so. The interpretation requests documented in agenda paper 8A(c) suggest the absence of a systemic problem with IAS 21. Furthermore, the mixed response to the Agenda Consultation Request for Views also highlights the lack of a clear need for a comprehensive review of the underlying conceptual basis for IAS 21.
21. If the IASB took on a wider comprehensive project, the staff believes that the scope of the project would need to be extended to include the conceptual basis for the translation of net investment in foreign operations for incorporating into an entity's consolidated financial statements. This is because of the inter-relationship between the requirements of the different parts of the Standard. It is also not clear that any

such review of the conceptual basis underpinning IAS 21 would fundamentally change the requirements in IAS 21. Although it is possible that such a review could lead to some improvements, it would involve considerable time and input from the IASB and the IASB's constituents.

22. Whilst we do not have evidence of a systemic problem with the requirements in IAS 21, we are aware of some concerns with aspects of IAS 21 arising in economies that are subject to more volatile exchange rates concerning presentation or measurement aspects (or both) of IAS 21.
23. We believe, therefore, that a more efficient use of resources would be for the IASB and the Interpretations Committee, as appropriate, to address concerns regarding specific aspects of IAS 21 as they are brought to our attention by our constituents. This approach could result in more timely narrow-scope amendments or interpretations, similar to the approach taken in respect of the recent limited-scope amendment to IAS 41 *Agriculture on Bearer Plants*.
24. Hence, the staff recommend that the IASB not undertake a comprehensive review of the conceptual basis for IAS 21, but instead consider the need for specific narrow-scope or other amendments to IAS 21 as and when the need arises. Other narrow-scope issues that have been raised to the IASB to date are considered separately in Agenda Paper 8A(c).
25. We also stress that the IASB will start the next Agenda Consultation in 2015. Interested parties will have the opportunity to comment to the IASB on priorities. The analysis in this paper, and the related papers from the KASB, should be a helpful input for the Agenda Consultation.
26. If the IASB agrees with the staff recommendation, the staff believe that the project should be removed from the list of active issues on the current Research Programme and the KASB should be formally thanked for providing the IASB with its analysis.
27. It will be important that the IASB communicate clearly the consequences of removing the item from the Research Programme. It means that we are no longer leading a

project driven by the IASB. However, removing the project from the Research Programme does not mean that the IASB has closed all consideration of IAS 21. On the contrary, doing so ensures that the IFRS Interpretations Committee is able to consider any requests for interpretation on their own merit—without the uncertainty of assessing whether that matter is being considered as part of an active project to replace IAS 21.

28. In a similar manner, the IASB can now also be more open to consider matters brought to its attention that could be addressed through narrow-scope amendments. The recent limited-scope amendment to IAS 41 *Agriculture* for bearer plants is an example where a change was able to be made on a timelier basis than would have been possible if the IASB had set out to replace IAS 41 in a major project.

Questions for the IASB

1. Does the IASB agree with the staff recommendation not to undertake a comprehensive review of the conceptual basis for IAS 21, but to consider the need for specific narrow-scope or other amendments to IAS 21 as and when the need arises and to monitor the situation as part of future agenda consultations?
2. If the answer to Question 1 is yes, does the IASB agree that the project for a comprehensive review of the conceptual basis for IAS 21 should be removed from the list of active issues on the current Research Programme and that the KASB should be formally thanked for providing the IASB with its analysis?