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STAFF PAPER

ASAF December 2014
IASB October 2014

ASAF Meeting
IASB Meeting

Project	**Foreign Currency Translation**		
Paper topic	The KASB Papers		

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Introduction

1. This paper contains the following papers submitted to the IASB by the Korean Accounting Standards Board (KASB) in respect of its work on foreign currency translation:
   (a) Agenda Proposal for Foreign Currency Accounting: The Amendment to IAS 21 *The Effects of Changes in Foreign Exchange Rates* is in Appendix A of this paper and discussed in Agenda Paper 8A(a)[1];
   (b) The Summary from the KASB's Research Report on Foreign Currency Accounting is in Appendix B and discussed in Agenda Papers 8A(b) and (c)[2]; and
   (c) Supplementary Document: *Discussion on the nature of foreign currency translation in terms of measurement on the level of Conceptual Framework* is in Appendix C and discussed in Agenda Paper 8A(b).
2. These papers are provided for reference only.

[1] Appendix A has not been reproduced for the ASAF meeting. See http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/October/AP08Ad-Research%20Project.pdf for the complete Agenda Paper 8A(d) for the IASB meeting in October 2014.

[2] The KASB's full Research Report is 85 pages long and has not been reproduced here.

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APPENDIX A

The KASB's Agenda Proposal for Foreign Currency Accounting

The Amendment to IAS 21 The Effects of Changes in Foreign Exchange Rates

Appendix A has not been reproduced for the ASAF meeting

APPENDIX B

Summary from the KASB's Research Report on Foreign Currency Accounting

Appendix – A Research Report on Foreign Currency Accounting

Foreign Currency Accounting Issues

2011.12.02.

Korea Accounting Standards Board

Summary

I. Introduction

Background

S1. With the globalization of capital flows, the foreign exchange market's volatility has been increasing. As the world went through the 1997 Asian financial crisis and the recent global financial crisis of 2008, entities in countries or jurisdictions that are affected by the significant changes in exchange rates raised concerns that the current accounting standards related to foreign currency translation might not reflect the true economic substance. Thus it was suggested that a comprehensive review of foreign currency accounting needs to be conducted in order to address such concerns.

S2. We agreed that it is appropriate to perform a review of IAS 21 in order to address such an issue. The reason behind this conclusion was because it was difficult to understand clearly the conceptual basis for the current translation requirement in IAS 21. For example, due to the lack of objective of foreign currency translation, it is difficult to understand what kind of information is supposed to be provided via the prescribed translation methods.

S3. That is why we thought that a comprehensive review of IAS 21 is needed in order to make the translation objective and methods clearer from a conceptual point of view.

S4. The comprehensive review would also provide a foundation for determining whether potential alternatives to be discussed in detail are appropriate.

Objective

S5. This report is prepared with an objective to provide **a foundation for carrying out the**

basic research into a comprehensive review of IAS 21. This report is also prepared as a reference material to ask the IASB to officially **include foreign currency accounting in their post-2011 agenda**.

Scope

S6. **This report focuses more on the topic of "translation of foreign currency transactions"** [1] than the topic of "translation of functional currency financial statements"[2] since most of the issues directly raised by stakeholders were related to the former topic.

II. Objective of Foreign Currency Translation

Background

S7. Since the objective of foreign currency translation is not specifically described in IAS 21, it is difficult to understand what kind of information is supposed to be provided via foreign currency accounting.

Findings

S8. In order to understand the objective of foreign currency translation implied in IAS 21, the objective of foreign currency translation in SFAS 52 (US GAAP) was referred to, and we supposed that the objective of foreign currency translation in SFAS 52 is closely related to the concepts of foreign currency risk and economic exposure.

Suggestions

S9. We deemed it necessary to discuss the following issues when determining the objective

[1] 'translation of foreign currency transactions' indicates ' reporting at the ends of subsequent reporting periods', the paragraph 23 of IAS 21

[2] 'translation of functional currency statements' indicates 'translation to the presentation currency' , the paragraph 39 of IAS 21

of foreign currency translation in IAS 21.

- Clear and accurate definition of foreign currency risk:
  In current IFRS 7, the definition of foreign currency risk is described as pertinent only to financial instruments. However, there should be clear definitions of terms because foreign currency risk is not mentioned in IAS 21 and if the definition in IFRS 7 is applied to IAS 21, non-financial instruments would be interpreted as carrying no foreign currency risk.

- Consideration of limits to accounting exposure:
  One should consider that economic exposure may not always be properly reflected in the financial statements.

- Separate definitions for the objective of “translation of foreign currency transactions” and the objective of “translation of functional currency financial statements”:
  Accounting treatments for translation of foreign currency transactions and for translation of functional currency financial statements differ from each other, and consequently, the objectives of the two aforementioned translations ought to be different from each other.

III. Relationship between Foreign Currency Translation and Measurement

Background

S10. IAS 21 lacks conceptual discussions on measurement basis for foreign currency translation methods.

Findings and Issues

S11. Translation in IAS 21 may be conceptually defined from one of the following two viewpoints:

(a) Viewpoint of the temporal method[3]

(b) Viewpoint of fair value measurement

S12. From the viewpoint of the temporal method, translation is viewed more as an inevitable accounting procedure that must be executed to state amounts in one currency rather than measuring foreign currency risk. Therefore, using the economic exposure concept in determining the objective of foreign currency translation would be inconsistent with this view.

S13. **The first issue** that arises in the viewpoint of fair value is that **the applicable principle for nonmonetary items and the applicable principle for monetary items would differ from each other**.

- Monetary item: The principle applied to monetary items views reflecting some changes in fair value as useful. In other words, it assumes that, even though an item itself is not measured at fair value in entirety, recognition of a change in exchange rate, i.e. a part of total fair value changes, provides more useful information.

- Nonmonetary item: The principle applied to nonmonetary items views it inappropriate to reflect only some fair value changes. In other words, it assumes that if an item is not measured at fair value, recognition of a change in exchange rate, i.e. only a part of fair value changes, does not provide useful information.

S14. **The second issue** that arises in the viewpoint of fair value is about **accounting treatment when the market exchange rate is unable to reflect fair value.**

- According to IFRS 13, the fair value measurement standard, when the market price is unable to represent fair value under exceptional circumstances, the fair value is generally calculated using valuation techniques.
- When the volume or level of activity in the market has significantly decreased, it may indicate that the market price does not represent fair value.

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[3] Refer to paragraph 3.9-3.10 for description of 'temporal method'

- IFRS 13 may be applied to the exchange rate market when liquidity significantly decreases due to intensified fluctuations in exchange rates.
- In IAS 21, however, there is no consideration given to this issue.

S15. We also observed that IAS 21, specifying only the translation methods for items measured at historical cost and at fair value, lacks explicit requirements for nonmonetary items measured by other measurement basis (e.g., provisions in compliance with IAS 37).

Suggestions

S16. **From the temporal method point of view**, further discussions are needed on **the appropriateness of translating monetary items measured at amortised cost using the current exchange rate**.

S17. **From the viewpoint of fair value measurement**, we suggest the following:

- **To resolve the problem of different principles applied to nonmonetary items and monetary items, (a) or (b) as below can be considered:**
  (a) Eliminating requirements related to nonmonetary items in IAS 21, or
  (b) Translating all items at current rates without the distinction between monetary and nonmonetary items.

- When market exchange rates do not reflect fair values under exceptional circumstances, it would be more appropriate to specify in IAS 21 cases where the market rates are unable to reflect fair values under exceptional circumstances and alternative accounting treatments accordingly.

S18. Translation requirements about nonmonetary items measured at a measurement basis other than historical cost or fair value should be clearly stated in IAS 21.

IV. Distinguishing Monetary and Nonmonetary Items

Background

S19. Questions arise about the theoretical basis of the translation method required in IAS 21, which is based on the monetary/nonmonetary distinction. Also, there are also cases in which the distinction between monetary and nonmonetary items is ambiguous.

Findings

S20. The monetary/nonmonetary method was used since 1950s but SFAS 8 adopted the temporal method instead of monetary/nonmonetary method. However, although SFAS 52 did not adopt the monetary/nonmonetary method, the concept was reused.

Suggestions

S21. We suggest clarifying the theoretical basis for using the monetary/nonmonetary concept, and seeking alternatives to the monetary/nonmonetary distinction.

- Clarification of theoretical basis for using the monetary/nonmonetary concept:
  It was possible to explain the monetary/nonmonetary method used in the past with theories like the purchasing power parity because none of the nonmonetary items are translated according to the method.[4] However, under the current foreign currency translation method, such theories cannot provide a basis because those nonmonetary items measured at fair value are translated, rather than not translating nonmonetary items as a whole.

- Consideration to be given to alternatives to the monetary/nonmonetary distinction:
  There are cases in which the distinction between monetary and nonmonetary items is ambiguous when an item has both monetary and nonmonetary characteristics (e.g., foreign currency denominated available for sale debt

[4] Under the assumption that the purchasing power parity holds, a change in foreign exchange rate is exactly offset by a change in price of the foreign currency of an item, which justifies non-translation for that item. For example, when foreign exchange rate decreases by 10%, the price of the foreign currency of a nonmonetary item increases by 10%, offsetting foreign exchange loss, and consequently it is unnecessary to translate the nonmonetary item.

instrument).

V. Definition of Functional Currency

Background

S22. The definition of a foreign operation is interpreted in a restrictive manner in IAS 21. A foreign operation is defined in IAS 21 as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity. Therefore it may be interpreted as that those other than the legal entities specified in the definition may not be defined as foreign operations.

Findings

S23. Based on the definition of a reporting entity in "Exposure Draft: Conceptual Framework for Financial Reporting – The Reporting Entity,"[5] published by the IASB and the statement in SFAS 52 that "in some instances, a foreign entity might have more than one distinct and separable operation,"[6] we noted that there is no reason to limit a foreign operation to those prescribed in IAS 21.

Suggestions

S24. The definition of a foreign operation needs to be amended so that the functional currency can be determined according to the economic substance.

VI. Recognition of Foreign Exchange Gains or Losses

Background

S25. IAS 21 does not clearly point out what the objective of translation is and thus it is

[5] Refer to "Exposure Draft: Conceptual Framework for Financial Reporting – The Reporting Entity" by IASB, March 2010

[6] Paragraph 43 of SFAS 52

impossible to determine how the resulting foreign exchange gains and losses should be recognised in order to conform to the objective.

Findings

S26. IAS 21 requires foreign exchange gains and losses to be recognised in profit or loss for the period resulting from translation of foreign currency transactions involving monetary items. Judging from this requirement, IAS 21 seems to view a change in exchange rates as a separate event that occurred to a reporting entity and thus regard that it is appropriate to recognise the foreign exchange gains and losses in profit or loss, i.e., as realised gains and losses, since the effect of a rate change has direct cash flow effects on the monetary item.

S27. However, there are cases where a rate change has a high possibility of reversal, that is, a low possibility of realisation into cash flows and thus it is not appropriate to recognise foreign exchange gains or losses of all monetary items as realised gains or losses.

Suggestions

S28. We believe there is a **need to examine whether foreign exchange gains or losses should be recognised in profit or loss or in other comprehensive income based on the distinction between current items and non-current items**. We believe so because this approach is consistent with accrual basis accounting, that is, the effects of rate changes having cash flow effects are recognised in the same period in which the causative event occurred. Furthermore, fluctuation of profit or loss account would be reduced by recognising foreign exchange gains or losses of non-current items which have a high possibility of reversal of such gains or losses. However, additional reviews should be conducted to determine if and when foreign exchange gains or losses of non-current items recognised in other comprehensive income should be recycled.

S29. **An alternative that recognises foreign exchange gains or losses of all monetary items in other comprehensive income may be considered.** Although this method may be able to reduce complexity caused by recycling as well as profit or loss fluctuation

caused by translation, in the absence of any conceptual definition for other comprehensive income, this method recognises foreign exchange gains or losses of short-term trading items in other comprehensive income even though the items have a high likelihood of immediate realisation. Therefore, conceptual examination of other comprehensive income should precede.

VII. Linked Presentation

Background

S30. Hedge accounting has been introduced because general accounting treatments cannot present hedging activities of a reporting entity. The objective of hedge accounting is to reflect in the financial statements and thus help users of the financial statements to understand how the management of an entity deals with the risks the entity faces as well as the resulting financial consequences.

S31. However, presenting hedged items and hedging instruments in gross amounts would mislead the users of financial statements because the gross presentation of hedging activities of the reporting entity would not be in accordance with the economic substance.

Findings

S32. Linked presentation shows exactly the same information as “unlinked” presentation. Furthermore, linked presentation even provides additional information showing that certain assets and liabilities are significantly related. Also, linked presentation explains the fact that derivatives are used for the purpose of hedging activities.

Suggestions

S33. It is true that the current gross presentation method has many advantages. However, we believe that there is a need to examine linked presentation for fair value hedge accounting in order to more appropriately present hedge accounting and provide useful

information to the users of financial statements.

VIII. Miscellaneous

S34. The following issues may be discussed further:

- Convergence between IFRSs and U.S. GAAP
- Consistency across IFRSs
- Review of Alternative Exchange Rates
- Practical issues raised by the Working Group
- Other Practical Issues

S35. Items that require convergence between IFRSs and U.S. GAAP are as follows:

Items	IFRSs	U.S. GAAP
Exchange difference of available for sale debt instruments	Effects of rate changes are recognised in profit or loss for the period.	Effects of rate changes are recognised in other comprehensive income
Accounting treatment in hyperinflationary economies	Restate financial statements in terms of the general level of prices when translating into presentation currency.	Financial statements of an entity are remeasured as if the functional currency were the reporting currency.

S36. The following should be reviewed in order to enhance consistency across IFRSs:

- The difference between the definition of foreign currency risk in IFRS 7 and that implied in IAS 39.
- The basis for recognising exchange differences of monetary items in standards other than IAS 21 (e.g., in ‘Borrowing Costs’ in IAS 23, exchange differences are not immediately recognised in profit or loss for the period, but this is not referred to as an exception in IAS 21).

S37. In the review of alternative exchange rates, an ex post empirical analysis showed that, when exchange rates fluctuate rapidly, applying a moving average exchange rate instead of a nominal exchange rate as of the balance sheet date better reflected the economic substance. Therefore, further discussions are needed on the appropriateness or practical applicability of such exchange rate.

S38. Practical issues raised by the Working Group are as follows:

- Guidelines are needed for determining average exchange rate when an average exchange rate is used instead of the exchange rate at the transaction date (e.g., a general methodology, periods for average exchange rates, etc.).
- For translation of foreign currency transactions, there are accounting treatments specified for using a number of different exchange rates or cases where exchange between two currencies is temporarily unavailable. However, there is no such accounting treatment specified for translation of functional currency financial statements, and thus related guidelines should be provided.

S39. Other practical issues include the following:

- For advance receipt denominated in foreign currency, there is an issue of whether sales amount should be recognised using the exchange rate at the time of recognising the sale or the exchange rate at the time of recognising the advance receipt since unearned revenue is a nonmonetary item.

APPENDIX C

The KASB's Supplementary Document

Discussion on the nature of foreign currency translation in terms of measurement on the level of Conceptual Framework

[Supplementary Document]

Discussion on the nature of foreign currency translation in terms of measurement on the level of Conceptual Framework

This document is presented as supplement to paragraph 15.1 of the KASB's comment letter on the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*

Purpose and scope

Purpose

1. We note that Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* ('DP/2013/1') states that it does not deal with foreign currency translation[1]. However, we think that it is necessary for the IASB to address foreign currency translation during the course of developing a revised *Conceptual Framework for Financial Reporting (the 'Conceptual Framework').* The reasons are:

   (a) it is unclear how foreign currency translation is interpreted in terms of measurement as defined in the existing *Conceptual Framework*; and

   (b) a research project[2] on foreign currency translation would be carried out effectively once this conceptual issue is resolved within the context of the *Conceptual Framework*.

2. In this paper, we will identify differing views over the issue. We will also make suggestions for making changes to the *Conceptual Framework* under on each differing view.

Scope

3. We focus on conceptual aspects of **'reporting foreign currency transactions in the functional currency' (ie it relates to paragraphs 20 to 37 of IAS 21 *The Effects of Changes in Foreign Exchange Rates*)**. In other words, we **do not** examine conceptual aspects of 'foreign currency translation of financial statements' (ie it relates to paragraphs 38 to 49 of IAS 21).

4. The reason for limiting the scope is that the requirements relating to 'reporting foreign currency transactions in the functional currency' is the major part that stakeholders identified as causing significant problems in practice.

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[1] Paragraph 6.5 of DP/2013/1 states that:

> The IASB believes that the issues that are associated with the equity method of accounting and the **translation of amounts denominated in foreign currency** would be best dealt with when revising Standards on these topics. Consequently, this Discussion Paper does not discuss these topics. (emphasis added)

[2] According to the IASB work plan, foreign currency translation is classified as a research project item for which the timing of preliminary work has not yet been confirmed.

Overview

5. The topic we address in this paper is how the requirements of IAS 21 with respect to 'reporting foreign currency transaction in the functional currency' (hereinafter also referred to as '**foreign currency translation**') should be understood in terms of the concepts of measurement and measurement basis. It should be noted that we do not use the term 'foreign currency translation' in this paper to indicate the foreign currency translation of financial statements (ie translation from functional currency to presentation currency).

6. We note that the *Conceptual Framework* defines measurement as follows:

> Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement. (Paragraph 4.54)

7. We note that it is unclear how to interpret two characteristics of foreign currency translation in terms of the definition of measurement in the *Conceptual Framework*. The two characteristics are that: (1) foreign currency translation involves a process of **determining the monetary amounts in multiple currencies** (ie first in foreign currencies and then in the functional currency) and (2) in that process, **using an exchange rate** is required.

8. **The first characteristic** of foreign currency translation (ie determining the monetary amounts in multiple currencies) raises an issue as to what it means to report an amount in the functional currency when the amount has already been measured in a foreign currency. We identify three different views as follows:

   (a) foreign currency translation is a separate process from measuring a transaction in a foreign currency:

      (i) foreign currency translation is not a measurement (ie a **mechanical conversion**) **(View 1)**.

      (ii) foreign currency translation is another **separate measurement (View 2)**.

   (b) foreign currency translation is **part of a single measurement process**, inseparable from measuring a transaction in a foreign currency (ie it is part of measuring a foreign currency transaction and therefore measuring a foreign

currency transaction is complete when the transaction is reported in the functional currency). **(View 3)**

9. **The second characteristic** of foreign currency translation (ie using an exchange rate) raises questions as to which exchange rate should be used and how exchange differences[3] should be accounted for. In other words, specific questions would be as follows:

   (a) (Question 1) Which exchange rate should be used on subsequent reporting[4]?

   (b) (Question 2) Should exchange differences be recognised in profit or loss?

10. We think that the conceptual issue relating to the **first characteristic** should be addressed **in the *Conceptual Framework* project**; and that issues relating to the **second characteristic** should be addressed **in a research project** on foreign currency translation[5].

11. We also think that conceptual clarification on foreign currency translation during the course of the *Conceptual Framework* project **should precede** discussion in a research project. Unless the *Conceptual Framework* clarifies which view (ie Views 1, 2 and 3) is appropriate, a research project would have to address the questions (ie Questions 1 and 2) in the light of all of the three views. This is because each view would require different perspectives when dealing with the questions in a research project.

12. In the following, this paper is structured as follows:

    (a) Comparison of conceptual differences between Views 1, 2 and 3

    (b) Implications of the three views for the *Conceptual Framework* project

    (c) Suggestions

    (d) Appendix A—Preliminary analysis of the issues that could be addressed in a research project on foreign currency translation

    (e) Appendix B—Preliminary examination on the appropriate exchange rate for 'other cash-flow-based measurements'.

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[3] IAS 21 defines exchange difference as the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

[4] In terms of the requirements in IAS 21, 'subsequent reporting' means the requirements in paragraphs 23 to 26 of IAS 21.

[5] If the *Conceptual Framework* project addresses the conceptual issue relating to the first characteristic and thereby supports View 2, Question 2 may as well be addressed by the *Conceptual Framework* project rather than by a research project. The *Conceptual Framework* project may address Question 2 in terms of Section 8, 'Presentation in the statement of comprehensive income—profit or loss and other comprehensive income'. In this regard, paragraph A7 of Appendix A of this paper can be referred to.

Comparison of conceptual differences between Views 1, 2 and 3

13. In the previous section, we identified three different views on foreign currency translation with regard to measurement:

    (a) **(View 1)** Foreign currency translation is a mechanical conversion, separate from measuring a foreign currency transaction in a foreign currency.

    (b) **(View 2)** Foreign currency translation is a measurement, separate from measuring a foreign currency transaction in a foreign currency.

    (c) **(View 3)** Foreign currency translation is a measurement, inseparable from measuring a foreign currency transaction in a foreign currency.

14. In this section, we discuss conceptual differences between these three views.

View 1—Foreign currency translation is a mechanical conversion

15. This view is that:

    (a) reporting a foreign currency transaction in a foreign currency is a measurement, but reporting it in the functional currency (ie foreign currency translation) is not a measurement but a **mechanical conversion**;

    (b) in other words, foreign currency translation is an **inevitable accounting process** to report the amounts in one currency (ie functional currency) instead of reporting the amounts in multiple currencies (ie foreign currencies); and

    (c) because foreign currency translation is a mechanical conversion, the amount that is translated and then reported in the functional currency therefore does not have a measurement basis.

16. The description of the requirements in IAS 21 can be read to support this view because it does not use 'measurement' when referring to 'translation'. We note that paragraph 23 of IAS 21 describes that items are 'measured' in a foreign currency and then they are 'translated' into the functional currency. Paragraph 23 of IAS 21 is as follows:

    > 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 measured. (emphasis added)

View 2—Foreign currency translation is a measurement, separate from measuring a foreign currency transaction in a foreign currency

17. This view is that:

(a) reporting a foreign currency transaction in a foreign currency is one complete measurement process and reporting it in the functional currency (ie foreign currency translation) is another complete measurement process, separate from reporting a foreign currency transaction in a foreign currency;

(b) because foreign currency translation is a separate measurement, it has a separate measurement basis; and

(c) foreign currency translation **measures an exposure to currency risk;** an item would be translated into the functional currency subsequently when its exposure to currency risk changes.

View 3—Foreign currency translation is a measurement, inseparable from measuring a foreign currency transaction in a foreign currency

18. This view is that:

(a) measuring a foreign currency transaction is a **single measurement process** that consists of measuring it in a foreign currency and measuring it in the functional currency;

(b) because it is a single measurement process, **the measurement basis used in the functional currency is the same as that used in a foreign currency**;

(c) the purpose of using an exchange rate is not to measure an exposure to currency risk; instead a certain exchange rate is selected in order to keep the

measurement basis in the functional currency as same as that in a foreign currency.

19. To understand this view more clearly, it would be helpful to note the steps of the measurement process on subsequent reporting that is implicit in this view.

    (a) (Step 1) Determine the measurement basis of an item in the **functional currency.**

    (b) (Step 2) Identify the corresponding measurement basis in a foreign currency.

    (c) (Step 3) Measure the item in a foreign currency.

    (d) (Step 4) Obtain the exchange rate to use, which can align the measurement basis in the functional currency with that in a foreign currency.

    (e) (Step 5) Measure the item in the functional currency applying the exchange rate.

20. Take an example of applying the steps above to a certain non-monetary item: (Step 1) the measurement basis for a non-monetary item in the functional currency is determined to be fair value; (Step 2) identify that the corresponding measurement basis for the item in a foreign currency is fair value; (Step 3) measure the item in a foreign currency; (Step 4) obtain the exchange rate at the date when the fair value is measured in a foreign currency; (Step 5) measure the item in the functional currency applying the exchange rate at the date when the fair value is measured in a foreign currency.

21. As noted above, the measurement basis used in the functional currency should be the same as that used in a foreign currency in this view. We think that one of the ways to achieve this is to align the time frame (ie, past, present and future) of measurements basis in the functional currency with that in a foreign currency. In this regard, we note that 'cost-based measurements' relates to the past; 'current market prices' relates to the present; and 'other cash-flow-based measurements' relates to the future in terms of time frame, according to the classification of measurements (ie measurement bases) of DP/2013/1[6]. Consequently, the measurement basis of foreign currency translation should reflect the corresponding time frame of the measurement basis used in a foreign currency.

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[6] DP/2013/1 classified measurements into three categories: (1) cost-based measurements; (2) current market prices including fair value; and (3) other cash-flow-based measurements.

Implications of the three views for the *Conceptual Framework* project

22. In the previous section, we compared conceptual differences between Views 1, 2 and 3. In this section, we examine what changes the IASB needs to make to the *Conceptual Framework* if the IASB decides to take one of these views.

View 1—The *Conceptual Framework* should provide a definition of foreign currency translation

23. Should View 1 provide a conceptual basis for foreign currency translation, we think that it would be necessary to define the concept of foreign currency translation separately from the definition of measurement in the *Conceptual Framework* because foreign currency translation is not a measurement in this view.

View 2—The *Conceptual Framework* should categorise the measurement basis of foreign currency translation

24. Should View 2 provide a conceptual basis for foreign currency translation, we think that a revised *Conceptual Framework* would need to set out which measurement basis foreign currency translation belongs to. This is because this view regards that foreign currency translation is a separate measurement process and therefore has a separate measurement basis. In this regard, we think that the measurement basis of foreign currency translation would be classified in the category of 'current market prices including fair value' because 'measuring the exposure to currency risk' would mean 'measuring the fair value in a currency market at the measurement date'.

25. In addition, provided that foreign currency translation is considered a fair value measurement, taking this view would not only have implications for the *Conceptual Framework* but also for IFRS 13 *Fair Value Measurement*. IFRS 13, setting out general guidance applicable in measuring assets or liabilities at fair value, acknowledges that there are circumstances[7] in which an entity should use valuation

[7] Paragraph B38 of IFRS 13 describes such circumstances (ie a significant decrease in the volume or level of activity in relation to normal market activity) and states that if an entity determined that a transaction or quoted

techniques to measure fair value instead of using a quoted price (unadjusted) in the market. In this regard, foreign currency market would not be an exception although IFRS 13 does not specifically address foreign currency market. In other words, IFRS 13 would be able to apply to circumstances in a foreign currency market, in which valuation techniques should be used to measure fair value instead of using a quoted price (ie the current exchange rate)[8].

View 3—The *Conceptual Framework* should categorise the measurement basis of foreign currency translation (especially, in the case of financial assets and financial liabilities measured at amortised cost in a foreign currency)

26. Should View 3 provide a conceptual basis for foreign currency translation, we think that a revised *Conceptual Framework* would need to provide guidance on how foreign currency translation should be categorised in terms of measurement basis. The guidance might be described in a way that the measurement basis of foreign currency translation corresponds to the measurement basis of an item to measure in a foreign currency. In this regard, it would be important to provide further guidance on the case of financial assets and financial liabilities measured at amortised cost in a foreign currency. This is because DP/2013/1 describes that amortised cost used for those assets and liabilities can be classified either as 'cost-based measurement' or as 'cash-

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price does not represent fair value, an adjustment to the transactions or quoted prices are necessary. Paragraph B38 is as follows:

B38 **If an entity concludes that there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), further analysis of the transactions or quoted prices is needed.** A decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly. However, **if an entity determines that a transaction or quoted price does not represent fair value** (eg there may be transactions that are not orderly), **an adjustment to the transactions or quoted prices will be necessary** if the entity uses those prices as a basis for measuring fair value and that adjustment may be significant to the fair value measurement in its entirety. Adjustments also may be necessary in other circumstances (eg when a price for a similar asset requires significant adjustment to make it comparable to the asset being measured or when the price is stale).[Emphasis added]

[8] Refer to paragraph A5 of this paper.

flow-based measurements'[9].

Suggestions

27. Considering the nature of the conceptual issue as examined above, we think that the issue would be best dealt with when developing a revised *Conceptual Framework* instead of when carrying out a research project on foreign currency translation.

28. Consequently, we suggest that the IASB should:

    (a) address the topic of foreign currency translation during the course of the *Conceptual Framework* project;

    (b) clarify which view among the three views (ie Views 1, 2 and 3) is most appropriate within the context of the *Conceptual Framework*; and

    (c) consider making relevant changes to the *Conceptual Framework* with regard to measurement and measurement basis, including the changes we proposed in this paper.

29. We believe that a research project on foreign currency translation would be able to deal with relevant issues[10] efficiently after the *Conceptual Framework* resolves the conceptual issue as examined above.

[9] Paragraph 6.44 of DP/2013/1

[10] As noted in the section 'overview' of this paper, the issues would include: (a) which exchange rate should be used on subsequent reporting?; (b) should exchange differences be recognized in profit or loss? Preliminary analysis of these issues is also provided in **Appendix A** of this paper.

Appendix A—Preliminary analysis of the issues that could be addressed in a research project on foreign currency translation

A1 In the section 'overview' of this paper, we identified two questions arising from the second characteristic (ie using an exchange rate) of foreign currency translation that could be addressed in a research project on foreign currency translation. The two questions are as follows:

(a) **(Question 1)** Which exchange rate should be used on subsequent reporting?

(b) **(Question 2)** Should exchange differences be recognised in profit or loss?

A2 We performed a preliminary analysis on these questions in terms of each view (ie Views 1, 2 and 3). To remind us of what each view represents, we note Views 1, 2 and 3 as follows:

(a) (View 1) Foreign currency translation is not a measurement.

(b) (View 2) Foreign currency translation is a measurement, separate from measuring a foreign currency transaction in a foreign currency.

(c) (View 3) Foreign currency translation is a measurement, inseparable from measuring a foreign currency transaction in a foreign currency.

View 1—(Answer to Q1) Translate all items at the closing rate; and (Answer to Q2) Exchange differences should not be recognised in profit or loss

(Question 1) *Which exchange rate should be used on subsequent reporting?*

A3 We think that the appropriate exchange rate to use on subsequent reporting is the closing rate for **all** assets and liabilities, regardless of whether they are monetary items and non-monetary items. The reason why we think that using the closing rate at the end of the reporting date is the appropriate translation method is as follows:

(a) this view regards foreign currency translation as changing a unit of measure, as if changing a unit of measure from 'meter' to 'foot' by the standard of length;

(b) changing a unit of measure from 'meter' to 'foot' by the standard of length is based on a **single relative rate**;

(c) by analogy, the closing rate would represent the relative rate between two currencies at a specific point of time, which is an end of the reporting date.

(*Question* 2) Should exchange differences be recognised in profit or loss?

A4 We think that exchange differences should not be recognised in profit or loss because exchange differences would not represent any result from an entity's financial performance; in View 1, foreign currency translation is an inevitable accounting process just to report the amounts in one currency instead of reporting the amounts in multiple currencies. Whether exchange differences should be recognised in other comprehensive income (OCI) or other component of equity etc. would need further discussion.

View 2—(Answer to Q1) Translate items that are exposed to currency risk at the closing rate in 'normal circumstances'; and (Answer to Q2) Whether or not to recognise exchange differences in profit or loss may be addressed by DP/2013/1

(Question 1) *Which exchange rate should be used on subsequent reporting?*

A5 According to this view, we note that an item is measured subsequently when its exposure to currency risk changes. We think that the closing rate would be the appropriate exchange rate to use in 'normal'[11] circumstances because the closing rate would represent fair value in a currency market at the measurement date.

A6 In this sense, we think that it is hard to justify the requirements for non-monetary items as set out in paragraph 23 of IAS 21. The reason is as follows:

(a) in paragraph 23 of IAS 21, (1) non-monetary items that are measured at historical cost in a foreign currency are translated using the exchange rate at

[11] We used the word 'normal' because we believe that if currency market is suffering from a significant decrease in the volume or level of activity and therefore the quoted price, ie the closing rate, does not represent fair value, there may be circumstances where using the closing rate is not appropriate. In this vein, IFRS 13 can be referred to, as mentioned in paragraph 25 of this paper. This issue would need further work in a research project.

the date of the transaction; and (2) non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was measured;

(b) According to View 2, paragraph 23 of IAS 21 implies that exposures of non-monetary items to currency risk change only if non-monetary items are measured at fair value in a foreign currency;

(c) however, it is unreasonable to say that an exposure to currency risk varies depending on whether or not the items are measured at fair value in a foreign currency because measuring an item at fair value is an accounting policy choice for some non-monetary items (eg a choice between cost model and revaluation model in IAS 16 *Property, Plant and Equipment*).

(*Question* 2) Should exchange differences be recognised in profit or loss?

A7 We think that whether exchange differences should be recognised in profit or loss needs to be discussed in the context of how to draw a line between profit or loss and OCI. In this sense, we think that DP/2013/1 may need to address this question in Section 8, ‘Presentation in the statement of comprehensive income—profit or loss and other comprehensive income’.

View 3—(Answer to Q1) Translate items using the exchange rate that aligns the measurement basis of the items in the functional currency with that in a foreign currency; and (Answer to Q2) Recognise exchange differences in profit or loss when gains or losses from measuring an item in a foreign currency are recognized in profit or loss

(Question 1) *Which exchange rate should be used on subsequent reporting?*

A8 In View 3, the measurement basis used in the functional currency is the same as that used in a foreign currency. Consequently, the appropriate exchange rate to use would correspond to the measurement basis in a foreign currency. According to the classification of measurement bases set out in DP/2013/1, the appropriate exchange rate would be as follows:

(a) if an item is measured in a foreign currency in accordance with 'cost-based measurements', the item would be deemed to be measured in the functional currency in accordance with 'cost-based measurements' when it is translated using the exchange rate at the date of the transaction (**'historical rate**');

(b) if an item is measured in a foreign currency in accordance with 'current market prices', the item would be deemed to be measured in the functional currency in accordance with 'current prices' when it is translated using the **closing rate**;

(c) if an item is measured in a foreign currency in accordance with 'other cash-flow-based measurements', the item would be deemed to be measured in the functional currency in accordance with 'other cash-flow-based measurements' when it is translated using the **closing rate** in **'normal'** circumstances.

A9 In the case of 'other cash-flow-based measurements' as above, we used the word 'normal' because we think that using the closing rate may not be appropriate if it does not reflect the 'market's best estimate of future events'. Our argument for this is provided in **Appendix B** of this paper.

A10 On the basis of the understanding of this view (ie View 3) as above, we can examine the requirements of IAS 21 in the light of this view.

A11 With regard to monetary items, we note that the requirements for monetary items in IAS 21 may be at odds with this view because all monetary items are required to be translated using the closing rate, regardless of which measurement basis they have in a foreign currency. Take an example of a monetary item that is measured at amortised cost in a foreign currency. This monetary item would be translated using the closing rate in accordance with IAS 21. DP/2013/1 identifies that amortised cost measurement for financial assets and financial liabilities can be classified either as a 'cost-based measurements' or 'cash-flow-based measurements'. We note paragraph 6.44 of DP/2013/1.

> 6.44 The term 'cost-based measurements' is used in this Discussion Paper to refer to **amortised cost as used for some financial assets and financial liabilities**, cost less accumulated depreciation as used for many physical assets, and other measurements commonly referred to as cost or historic cost. However, **amortised cost measurement used for financial assets and financial liabilities could equally well be**

> **described as a cash-flow-based measurement** because it involves updated estimates of cash flows that are discounted using a locked-in discount rate. (emphasis added)

A12 Accordingly, it would be questionable whether translating this item using the 'closing rate' would lead to the same measurement basis in the functional currency as that in a foreign currency. This is because if amortised cost measurement is considered as 'cost-based measurement', using the historical rate would be appropriate; and if amortised cost measurement is considered as 'cash-flow-based measurements', we think that using the closing rate would be appropriate in a 'normal' circumstances because the closing rate used in this measurement category would 'normally' represent the 'market's best estimate of future events' (see **Appendix B** of this paper).

A13 With regard to non-monetary items, we think that the requirements of IAS 21 generally reflect this view[12].

(*Question* 2) Should exchange differences be recognised in profit or loss?

A14 We think that it would be appropriate to recognise exchange differences in profit or loss if gains or losses from measuring an item in a foreign currency are recognised in profit or loss. In other words, if an item is measured in a foreign currency and thereby the gains or losses from its measurement are recognized in OCI, exchange differences would have to be recognized in OCI, correspondingly. This implies that the accounting of measuring a foreign currency item in the functional currency is aligned with that of measuring it in a foreign currency. This (aligned) accounting would also be consistent with the purpose of this view, which is to align the measurement basis of an item in the functional currency with that in a foreign currency.

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[12] Paragraph 25 of IAS 21 prescribes the requirements for some other cash-flow-based measurements (ie net realizable value of inventories and recoverable amount, more specifically, value in use of non-monetary assets), describing that an entity should use the exchange rate at the date when that value is determined (eg the closing rate at the end of the reporting period). However, we note that Paragraph 23 of IAS 21 is not explicit on this point.

If IAS 21 were to fully reflect this view, we think that IAS 21 needs to explicitly set out which exchange rate should be used when an items is measured in a foreign currency in accordance with 'other cash-flow-based measurements' because paragraph 23 of IAS 21 sets out the requirements only for 'cost-based measurements' and 'current market prices'.

Appendix B—Preliminary examination on the appropriate exchange rate for 'other cash-flow-based measurements'

B1 In Appendix A of this paper, when addressing Question 1 in View 3, we presented that using the closing rate would be appropriate in 'normal' circumstances in the case of 'other cash-flow-measurements'. Appendix B provides reasons for why we used the word 'normal' in that description.

B2 IAS 36 *Impairment of Assets* prescribes how to measure 'value in use' when value in use is estimated in a foreign currency. We note paragraph 54 of IAS 36 as follows:

> 54 Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An entity translates the present value **using the spot exchange rate** at the date of the value in use calculation.

B3 We also note relevant paragraphs of Basis for Conclusions on IAS 36 as follows:

> 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 currency 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).
>
> 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.** (emphasis added)

B4 On the basis of the paragraphs of IAS 36 as noted above, we think that in most cases, using the closing rate (ie spot rate) for 'other cash-flow-based measurements' would be appropriate because it would normally reflect the 'market's best estimate of future events'. However, we think that there can be a circumstance in which using the closing rate may not be appropriate if it does not reflect the 'market's best estimate of future events', although we acknowledge that paragraph BCZ50 of IAS 36 indicates that IASC decided to require using the closing rate even in a circumstance where the closing rate does not reflect the 'market's best estimate of future events'.

B5 For more detail information about why we think that using the closing rate may not be appropriate in a circumstance where the closing rate does not reflect the 'market's best estimate of future events' and what alternatives can be considered, refer to our comment letter (CL217) to Request for Views *Agenda consultation 2011* issued by the IASB in July 2011.