IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 21—*The Effects of Changes in Foreign Exchange Rates***		
Paper topic	Foreign exchange restrictions and hyperinflation		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a submission requesting guidance on the translation and consolidation of the results and financial position of foreign operations in Venezuela under IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The issue arises because of strict foreign exchange controls over the exchange of the Venezuelan Bolivar Fuerte (VEF) combined with Venezuela's hyperinflationary economy.

2. This paper provides a summary of the issues, the staff's research and the options available to the Interpretations Committee. The paper asks the Interpretations Committee whether it agrees with the staff's agenda criteria assessment and whether it agrees with the staff recommendation not to take the issue onto its agenda.

3. The paper is structured as follows:

    (a) Background

    (b) Summary of the submission

    (c) Summary of outreach

    (d) Staff identification of the accounting issues

    (e) Agenda criteria assessment

(f) Options for the Interpretations Committee

(g) Staff recommendations.

Background

Accounting for hyperinflation

4. Venezuela has generally been considered to have a hyperinflationary economy (as defined in IAS 29 *Financial Reporting in Hyperinflationary Economies*) since 2009.

5. Entities whose functional currency is that of a hyperinflationary economy are required under IAS 29 to state their financial statements in terms of the measuring unit current at the end of the reporting period by applying a general price index.

6. Groups consolidating such subsidiaries translate these inflation-adjusted subsidiary financial statements into the group's presentation currency (for example US$) at the closing exchange rate in accordance with IAS 21.

Foreign exchange controls in Venezuela

7. There are strict Venezuelan government controls over exchanging VEF. We understand that there are currently three official exchange mechanisms in Venezuela, as summarised in Appendix D. Each of these has different exchange rates, available to different entities for different types of transactions depending upon specific circumstances. Furthermore, there are restrictions on the amount of currency that can be exchanged though these exchange mechanisms.

8. There have been, and continue to be, changes to the official exchange rate mechanisms in Venezuela. Recent press articles have reported that the Venezuelan government plans to make a transition over time to only one official exchange rate.

Summary of submission

9. The submitter has asked the Interpretations Committee to review the current approach for translating and consolidating foreign operations in Venezuela. The submission is reproduced in Appendix C.

10. Below is a summary of the submitter's observations based on the submission and our discussions with the submitter:

    (a) Prevalent practice is to translate foreign operations into the group's presentation currency using official exchange rates.

    (b) For operations with a VEF functional currency the official CENCOX fixed exchange rate has typically been used as the closing rate under IAS 21 on the basis that it was the only official exchange mechanism available to a group.

    (c) In the submitter's experience, such a rate is only available for a relatively limited amount of currency in practice, with the result that a Venezuelan subsidiary may have more cash in VEF than it is able to convert into US$ (and hence repatriate) using the official exchange rate mechanisms.

    (d) Because of foreign exchange controls, the official exchange rates for VEF (in particular the fixed CENCOX and variable SICAD I rates) do not, according to the submitter, reflect the local rate of hyperinflation. Hence, in the submitter's view, a substantial devaluation of the VEF from the official fixed exchange rate in the future is almost certain.

11. As a consequence, the submitter is concerned that, from an economic perspective, the financial statements group accounts appear to:

    (a) overstate the Venezuelan operation's assets and liabilities (including local cash held in VEF);

    (b) overstate income from the Venezuelan operations (which is further compounded by the IAS 29 inflation adjustments); and

    (c) understate foreign exchange losses (or gains) in profit or loss arising on US$ (or other non VEF) denominated balances in Venezuela. This

includes intercompany balances that eliminate on consolidation, because the foreign exchange gains and losses that arise in the subsidiary remain in profit or loss on consolidation (unless they are considered to be part of the group's net investment in the foreign operation).

12. Specifically, the submitter has requested guidance in three areas, as follows:

(a) which exchange rate to use if there is more than one rate when translating Venezuelan foreign operations into the group's presentation currency;

(b) whether expected devaluation losses arising on local VEF denominated cash or other financial assets can or should be recognised in the consolidated financial statements where they have in effect occurred; and

(c) whether the IAS 29 inflation adjustments in the local financial statements can or should be reversed in the consolidated financial statements to better reflect the underlying business performance of the foreign subsidiary.

Summary of outreach

Request for feedback

13. In order to gather information about the issue described in the submission, we sent requests to securities regulators, members of the International Forum of Accounting Standard Setters and the IFRS technical teams of the international networks of large accounting firms. Specifically, we asked:

(a) In your jurisdiction are you aware of any entities that have significant operations in a functional currency that is subject to foreign exchange controls (which is often combined with high or hyper inflationary economies)?

(b) If yes:

(i) *Do such entities experience similar issues?*

(ii) *What is their experience of repatriating cash from those countries?*

(iii) *If there are several exchange rates available, what exchange rates are used for translating the foreign operation into the group's presentation currency and why? Are you aware of any diversity in practice within or across industries or jurisdictions and why this might be?*

(iv) *Is it common for such groups to use any alternative measures (including non-GAAP measures) to explain their results because of the consequences of applying an official exchange rate that is subject to exchange controls? If so, what are these?*

14. In addition, we held informal discussions at the Global Preparers Forum (GPF) and with representatives of Emerging Markets from the IFRS Advisory Council. We also sent the above outreach request to members of the GPF. Furthermore, we spoke to one member of the Capital Advisory Markets Committee who had expressed in an interest in the issue.

15. The views received represent informal opinions and do not reflect the formal views of those organisations.

Summary of responses

16. We received 19 responses to our written outreach request: 5 from large accounting firms; 1 from a preparer; 3 from regulators and 10 from National Standard-Setters. By region, responses from National Standard-Setters were received from:

Geographical region	**Number of respondents**
Asia-Oceania	3
Europe	2
North America	2
South America	2
Africa	1
Total respondents	10

Geographical extent of issue

17. Half of the National Standard-Setters that responded to our outreach replied that they were not aware of any entities in their jurisdiction that had significant foreign operations in Venezuela or other countries with foreign exchange controls.

18. The other respondents noted that they were aware of several entities with foreign operations in controlled foreign exchange and hyperinflationary or high-inflationary environments, some of which were significant. These respondents observed that in their experience these entities encountered similar issues to those described in the submission.

19. Respondents observed that, in their experience, the issues are currently most pervasive for entities with significant foreign operations in Venezuela. Similar issues also arise, albeit to a lesser extent and not always combined with hyperinflation, in respect of foreign operations in Argentina and a number of African and Middle Eastern countries, including Syria, Sudan, South Sudan, Iran and Egypt. Some respondents commented that although there are some similarities between the affected countries, in each case the facts and circumstances differ.

Repatriation of cash

20. Those consulted observed that in the affected countries foreign currency is extremely difficult to obtain and very little repatriation is possible. It was also noted that the difficulty in remitting funds out of such countries sometimes leads to the development of alternative currency markets.

Multiple exchange rates

21. Outreach indicated that widespread practice is for entities to use judgement to determine the official rate that best reflects the rate at which the entity will be able to remit funds from its foreign operations in Venezuela (ie the rate at which future cash flows could be settled), to translate an entity's net investment in foreign operations in Venezuela.

22. However, the combination of (i) changing official market mechanisms, (ii) lack of clarity over which rates are available to an entity and (iii) a lack of

exchangeability, leads to diversity in practice as to which of the multiple official exchange rates in Venezuela are used to translate an entity's net investment in foreign operations in Venezuela.

23. Most of those consulted noted that in their experience practice was to only use official exchange rates that were legally available for the financial reporting of Venezuelan operations, despite the lack of exchangeability in practice. However a few respondents noted some diversity, observing that in the past some entities did not use the rate that was officially available to them, but instead used another higher governmental rate even though legally they were not eligible to use that rate for dividend remittances. This was because in practice they were unable to use either rate and therefore selected the rate that they believed to be closer to economic reality.

24. For entities with foreign operations in Argentina, limited diversity had been observed in practice, because there is only one official rate. A few respondents observed that unofficial rates from parallel market(s) (for example through arbitration with foreign currency bonds that are acquired locally and sold abroad) were not generally used for financial reporting purposes because the rate is not quoted, the cash is not available for immediate delivery and entities also take on the wider risk associated with the bonds (or underlying asset) for a period of time (typically 1-2 days). However one respondent was aware of some entities using such a parallel market rate where they had concluded that they will or could use the parallel market for the repatriation of capital or dividends.

25. A respondent noted that in some African and Middle Eastern countries the exchange rate used can be highly subjective and differ from entity to entity based on its view of the rates available in the unofficial market. The rate used depends on an analysis of potential rates available to pay foreign suppliers and repatriate dividends, if possible. Alternative calculations of exchange rates are used in limited cases based on local prices of commodities such as gold and oil.

Disclosure and use of alternative measures

26. Our outreach indicates that it is not common practice for entities to use alternative measures (including non-GAAP measures) to explain their results because of the

consequences of applying an official exchange rate that is subject to exchange controls. Despite this, two examples of alternative measures that had been observed by a few respondents were:

(a) excluding foreign exchange gains and losses (particularly in reporting periods when a devaluation had occurred) from profit or loss measures (eg EBITDA excluding foreign exchange); and

(b) an alternative measure using an implied rate for translation that is considered to result in a more accurate economic reflection of the financial results and position.

27. Those consulted noted increasing levels of other disclosures when the impact of foreign exchange restrictions on a foreign operation is significant, although often not many details are provided. The disclosures observed in practice include:

(a) an explanation of risks created by high inflation and exchange control regulations, including in some instances, sensitivity analyses (for example, the potential impact of a higher exchange rate if material to the group as a whole);

(b) constant currency information;

(c) exchange rate accounting policy;

(d) use of a table to show the impact between the official fixed rate and the latest rate observed for their transactions (ie a SICAD variable rate), where the entity had recently moved from using the official fixed rate to a SICAD variable rate for financial reporting purposes; and

(e) An explanation in the management report to explain the relative impact in profit or loss of the exchange rate and hyperinflation.

28. Furthermore, we note that the United States SEC[1] has been encouraging greater disclosure in respect of US registrants that have significant foreign operations in

[1] For example, the SEC's International Practices Task Force Highlights for May 2013 noted staff observations that an official exchange rate exists in Argentina that is significantly more favourable than a parallel market rate (referred to as the Blue Chip rate). The staff reminded registrants that have significant operations in Argentina, that when the exchange rate used for re-measurement purposes or translation of financial statements may not reflect economic reality, additional disclosure in MD&A may be necessary

both Venezuela and Argentina, depending upon the nature and size of operations when the exchange rate used for re-measurement purposes or translation of financial statements may not reflect economic reality.

Staff identification of the accounting issues

29. On the basis of the concerns raised, the accounting issue primarily stems from the *closing rate* used on the application of IAS 21 on translation of the net investment in the foreign operation, because there are (i) several different exchange rates and (ii) control restrictions over both the exchange *rate* and the *amount* of local cash that can be exchanged.

30. The primary issues are therefore:

    (a) Issue 1: which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?

    (b) Issue 2: what rate should be used when there is a longer-term lack of exchangeability?

31. If it is not possible to resolve the concerns raised through addressing Issues 1 and 2 above, then addressing the following secondary issues raised by the submitter, may alleviate, in part, the accounting anomaly currently observed:

    (a) Issue 3: if the closing rate used for accounting purposes does not reflect the local rate of inflation in a hyperinflationary economy[2], should or could entities disregard the IAS 29 inflation adjustments on consolidation?

    (b) Issue 4: should entities further impair their foreign operation's local currency financial assets on consolidation to reflect expected future

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(eg summarised financial information of the operations; disclosure of exchange rate used; disclosure of the net monetary assets and liabilities by currency; and discussion of the potential impact of a change in exchange rates).

[2] Similarly you could have the converse scenario, in which the official rate of inflation does not reflect the real rate of inflation, as observed through exchange rates.

devaluations of the local currency that are expected to occur before those financial assets can be exchanged into other currencies?

32. In this paper, we will address the primary issues, Issues 1 and 2. Depending upon the outcome of these discussions we will ask the Interpretations Committee whether we need to address Issues 3 and 4 at a later date.

Agenda criteria assessment

33. In this section, we assess Issues 1 and 2 against the agenda criteria of the Interpretations Committee described in paragraphs 5.16–5.17 of the IFRS Foundation *Due Process Handbook*. Please refer to Appendix B of this Agenda Paper for details of the agenda criteria and a summary of the assessment of these issues against the agenda criteria.

Issue 1: which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?

34. This issue arises because there is no specific guidance in IAS 21 regarding which exchange rate, out of multiple rates, to select for the purposes of translating an entity's net investment in the foreign operation.

35. However paragraph 26 of IAS 21 gives guidance on which exchange rate to use when reporting foreign currency transactions in the functional currency in the local entity's financial statements as follows:

> When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date.

Does Issue 1 have a widespread effect?

36. Outreach indicates that Issue 1 has a widespread effect that can have a material effect on those affected. Respondents observed several entities, across several jurisdictions, with significant foreign operations in Venezuela that have to deal with multiple exchange rates.

Is there diversity?

37. Outreach indicates that widespread practice is to extend the principle noted in paragraph 35 above to the translation of an entity's net investment in a foreign operation, when there are multiple rates. That is, the rate used is that at which the entity will be able to remit funds from its foreign operations in Venezuela (ie the rate at which future cash flows could be settled when viewing the net investment as a whole).

38. Instead of there being diversity over the principle to apply under IAS 21, outreach indicates that diversity in practice arises because of different, changing, and often unclear, facts and circumstances, and a lack of exchangeability (which is considered in Issue 2).

Can Issue 1 be resolved efficiently within the confines of existing IFRSs?

39. Extending the existing principle in IAS 21 paragraph 26 to the translation of a net investment in a foreign operation would provide a quick resolution, but would not be efficient because of the lack of diversity in the principle that is currently applied.

Staff conclusion

40. The lack of diversity regarding which rate to use when there are multiple rates in practice means that, despite the widespread applicability, the proposal to provide guidance on which rate to use to translate an entity's net investment in the foreign operation when there are multiple exchange rates does not meet the agenda criteria.

Issue 2: what rate should be used when there is a longer-term lack of exchangeability?

41. Paragraph 26 of IAS 21 gives guidance when exchangeability between two currencies is *temporarily* lacking in the context of reporting foreign currency transactions in the functional currency in the local entity's financial statements:

> If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.

42. However Issue 2 arises because IAS 21 is silent about what rate to use when exchangeability is lacking on a longer-term basis, either in the foreign entity's own financial statements or when translating the net investment for consolidation purposes.

Does Issue 2 have a widespread effect?

43. As with Issue 1, Issue 2 has a widespread effect that can have a material effect on those affected. As well as observations about entities with foreign operations in Venezuela, similar restrictions over exchangeability and exchange rates are experienced in foreign operations in some other countries (eg Argentina, some African/Middle Eastern countries), although to a lesser extent.

Is there diversity?

44. Outreach indicates that there is *some* diversity in practice when there is a longer-term lack of exchangeability:
    (a) In general, the exchange rate used under IAS 21 is the one that the entity technically qualifies for to remit funds from the net investment (or settle the transaction in the local financial statements) despite the government limitation on the amount of currency available through that exchange mechanism.
    (b) However, in some instances another government rate has been used for accounting purposes, even though it is not legally technically available to the entity for the transaction/net investment being translated. This alternative has been justified on the basis that neither rate is available in practice and so the rate selected for IAS 21 purposes is the one judged to most closely reflect economic reality.

Can Issue 2 be resolved efficiently within the confines of existing IFRSs?

45. Arguably, when there is a lack of exchangeability for longer than a 'temporary' period, the definition of 'closing rate' in IAS 21 is not met. This is because IAS

21 defines closing rate as 'the exchange rate (ie the ratio of exchange for two currencies) for immediate *delivery* at the end of the reporting period'—and an exchange of currencies can only be *delivered* if the exchange mechanism/market is available to the entity.

46. To appropriately address Issue 2 would therefore require an exception to the definition of 'closing rate' which could not be addressed through an interpretation of an existing Standard or an Annual Improvement, because it would require a change to an existing principle in IAS 21. We discuss whether the issue could be addressed in some other way later in this paper.

Staff conclusion

47. Issue 2, concerning the lack of exchangeability, has widespread applicability and some diversity in practice has been observed. Although the issue relates to specific circumstances, it is broad in nature in that it would represent an exception to the existing principles in IFRS. Hence, Issue 2 could not be addressed through an interpretation of an existing Standard or an Annual Improvement.

Questions for the Interpretations Committee

1. Do you agree that Issue 1 (issuing guidance on the use of multiple exchange rates for the translation of a net investment in a foreign operation) does not meet the Interpretations Committee's agenda criteria?
2. Do you agree that Issue 2 (issuing guidance on which rate to use when there is a lack of exchangeability) cannot be addressed through an interpretation of an existing standard or an Annual Improvement?

Options for the Interpretations Committee

48. In this section, we consider what options are available to the Interpretations Committee with respect to Issues 1 and 2.

Issue 1: which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?

49. As discussed above, outreach indicates that there is little or no diversity in practice regarding the principle to use when determining which of multiple rates should be used to translate an entity's net investment in a foreign operation.

50. Consequently, we recommend that the Interpretations Committee should not take Issue 1 onto its agenda.

Issue 2: what rate should be used when there is a longer-term lack of exchangeability?

51. The lack of exchangeability is not adequately addressed by IAS 21, which is causing concerns in practice. However, the issue cannot be addressed through an interpretation of an existing Standard or an Annual Improvement. We have therefore identified the following options available to the Interpretations Committee:

    (a) Option A: do not take the issue onto the Interpretations Committee's agenda, but highlight the issue to the IASB.

    (b) Option B: this is the same as Option A, but with the addition that the Interpretations Committee clarifies in its agenda rejection notice that disclosures should be given by those entities where the impact of foreign exchange restrictions is material as already required by existing Standards.

    (c) Option C: take the issue onto the Interpretations Committee's agenda, with a view to developing a recommendation for an amendment to IAS 21 for the IASB's consideration, after consulting the IASB.

Option A: agenda rejection

52. Under Option A we would acknowledge that there is a problem, but that the issue is too broad for the Interpretations Committee to take onto its agenda.

53. By making the IASB aware of the issue, the IASB has the option to address the issue, after balancing its priorities. We note that the IASB's current agenda includes research projects on foreign currency translation and high inflation, with the aim of considering whether there are issues that the IASB should address and if so, what the scope of such a project would be. This issue could be considered as part of that assessment.

Option B: agenda rejection, highlighting disclosure requirements

54. If the Interpretations Committee does not take the issue onto its agenda, disclosure can help users understand the accounting anomaly that arises. Hence Option B proposes to augment Option A, by highlighting that existing disclosure requirements in IFRS apply when the issue has a material impact on a reporting entity's financial performance and position.

55. Relevant disclosure requirements in IFRS include disclosure of:

    (a) significant accounting policies and significant judgements in applying those policies (IAS 1 paragraphs 117-124);

    (b) sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, which may include a sensitivity analysis (IAS 1 paragraphs 125-133);

    (c) the nature and extent of significant restrictions on an entity's ability to access or use assets and settle the liabilities of the group, or its joint ventures or associates (IFRS 12 paragraphs 10, 13, 20 and 22);

    (d) the nature and extent of risks (including foreign exchange risk) arising from financial instruments (from a qualitative and quantitative perspective and including sensitivity analyses) (IFRS 7 paragraphs 31-42 and B6-B24);

    (e) significant cash held by the entity that is not available for use by the group, including due to exchange controls (IAS 7 paragraphs 48 and 49); and

(f) the amount of foreign exchange differences recognised in profit or loss and other comprehensive income (IAS 21 paragraph 52).

56. Disclosure requirements (a), (b) and (c) above apply to the issue as a whole and therefore we believe are the most pertinent to highlight in an agenda rejection notice.

Option C: take the issue onto the Interpretation Committee's agenda

57. Under Option C, the Interpretations Committee would explore in future meetings whether it could develop some additional requirements for the IASB's consideration to address the concerns raised due to the lack of exchangeability of the local currency in foreign operations such as Venezuela.

58. This might involve developing requirements for the use of an alternative/ estimated exchange rate that better reflects economic reality when there is no long-term exchangeability of the local currency. For example, would it be possible to estimate the rate that might apply when the restrictions over exchangeability are lifted? Or would it be possible to estimate what the exchange rate at the measurement date would have been had there not been any exchange restrictions?

59. Alternatively, the Interpretations Committee could consider whether entities should further impair their foreign operation's local currency financial assets on consolidation to reflect expected future devaluations of the local currency that are expected to occur before those financial assets can be exchanged into other currencies (ie Issue 4).

60. The Interpretations Committee would need to consider the scope for any such proposals.

61. Before undertaking this option, we recommend consulting members of the IASB to ascertain their appetite for developing such requirements to address the issue.

Staff recommendations

Issue 1: which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?

62. As noted above, we recommend that the Interpretations Committee should issue an agenda rejection, on the basis that the Interpretations Committee has observed little or no diversity in practice regarding the principle to use when determining which of multiple rates should be used to translate an entity's net investment in a foreign operation. General practice is to use the exchange rate at which the entity will be able to remit funds from its foreign operations (ie the rate at which future cash flows could be settled when viewing the net investment as a whole).

Issue 2: what rate should be used when there is a longer-term lack of exchangeability?

63. Outreach has confirmed that the concerns raised due to foreign exchange restrictions faced by foreign operations in Venezuela are valid. The issue primarily arises because of the longer-term lack of exchangeability of the local currency, which we observe to be:
    (a) widespread;
    (b) leading to some diversity in practice; and
    (c) not addressed by the requirements in IAS 21.

64. The ideal answer therefore would be to develop an accounting solution that directly addressed the issue, which would lead to Option C, especially as an initial assessment suggests that the issue relates to specific narrow circumstances when there is a lack of exchangeability.

65. However, on the basis of conversations during outreach, the staff believe that developing such a solution would be difficult in practice because it would require a new or different principle from that currently in IAS 21 and could lead to questions about the basis for all foreign currency translations under IAS 21. Furthermore, this issue cuts across other issues that have been raised to the IASB with respect to IAS 21, which potentially could impact the scope of any proposed

solution to the issues raised. Therefore we believe that it may be more appropriate for the IASB to consider this issue as part of its broader research project on foreign currency translation.

66. This leaves the Interpretations Committee with Options A and B, both of which lead to agenda rejections. Highlighting existing disclosure requirements, as suggested in Option B, does not add anything new to, or clarify, existing IFRS. However, because of the accounting anomalies observed, sufficient disclosure is important when the impact of foreign exchange controls is material to understanding the reporting entity's financial performance and position. Consequently, we believe that it would be helpful to highlight some of the existing disclosure requirements in IFRS that apply in such circumstances.

67. Accordingly, we recommend that the Interpretations Committee issue an agenda rejection as proposed in Option B above, that:

    (a) acknowledges that there is a problem, but that the issue is too broad for the Interpretations Committee to take onto its agenda; and

    (b) notes that some existing disclosure requirements in IFRS apply when the issue has a material impact on a reporting entity's financial performance and position, including those in paragraphs 55(a), (b) and (c) above.

Questions for the Interpretations Committee

3. Does the Interpretations Committee agree with the staff's recommendation not to add the following issues to its agenda as proposed in paragraphs 62 and 67 above:

    (a) which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates (Issue 1); and

    (b) what rate should be used when there is a longer term lack of exchangeability (Issue 2)?

4. If the answer to Question 3 is 'Yes', does the Interpretations Committee agree with the wording of the tentative agenda decision in Appendix A of this Agenda Paper?

Appendix A—Proposed wording for the tentative agenda decision

IAS 21 *The Effect of Changes in Foreign Exchange Rates*—Foreign exchange restrictions and hyperinflation

The IFRS Interpretations Committee (the Interpretations Committee) received a request for guidance on the translation and consolidation of the results and financial position of foreign operations in Venezuela. The issue arises because of strict foreign exchange controls in Venezuela. This includes the existence of several official exchange rates which do not reflect the local rate of hyperinflation and restrictions over the amount of local currency that can be exchanged.

Concerns were raised that using the official exchange rate to translate an entity's net investment in a foreign operation in Venezuela appeared, from an economic perspective, to overstate the foreign operation's income, assets and liabilities in the group's consolidated financial statements.

The Interpretations Committee identified two primary accounting issues:

(a) Which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?

(b) What rate should be used when there is a longer-term lack of exchangeability?

With respect to the first issue, the Interpretations Committee observed little or no diversity in practice regarding the principle to use when determining which of multiple rates should be used to translate an entity's net investment in a foreign operation. Hence, despite the widespread applicability, the Interpretations Committee [decided] not to take the first issue onto its agenda.

With respect to the second issue, the Interpretations Committee observed that this issue is widespread, has led to some diversity in practice, and is not addressed by the requirements in IAS 21. However, the Interpretations Committee thought that addressing this issue is a broader scope project than it could address (because of related cross-cutting issues). Accordingly the Interpretations Committee [decided] not to take this issue onto its agenda.

However, the Interpretations Committee noted that several existing disclosure requirements in IFRSs would apply when the impact of foreign exchange controls is material to understanding the reporting entity's financial performance and position. Relevant disclosure requirements in IFRS include:

(a) disclosure of significant accounting policies and significant judgements in applying those policies (IAS 1 paragraphs 117-124);

(b) disclosure of sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, which may include a sensitivity analysis (IAS 1 paragraphs 125-133); and

(c) disclosure about the nature and extent of significant restrictions on an entity's ability to access or use assets and settle the liabilities of the group, or its joint ventures or associates (IFRS 12 paragraphs 10, 13, 20 and 22).

Appendix B—Assessment against the Interpretations Committee's agenda criteria

B1. Below we have assessed the issue against the agenda criteria of the Interpretations Committee as described in paragraphs 5.14–5.22 of the IFRS Foundation *Due Process Handbook*.

Source of issue		
Issues could include: the identification of divergent practices that have emerged for accounting for particular transactions, cases of doubt about the appropriate accounting treatment for a particular circumstance or concerns expressed by investors about poorly specified disclosure requirements (5.14). Concern about appropriate accounting treatment raised by submitter and confirmed through outreach.		
Criteria		
We should address issues(5.16):	**Issue 1: multiple exchange rates**	**Issue 2: longer-term lack of exchangeability**
that have widespread effect and have, or are expected to have, a material effect on those affected;	Yes. Outreach indicates that across jurisdictions there are several entities with significant foreign operations in Venezuela.	Yes. Outreach indicates that there are several entities with significant foreign operations in Venezuela and in some other countries with similar exchange control restrictions (eg Argentina, some African/Middle Eastern countries), although not to the same extent.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	No. Outreach indicates that there is no or little diversity due to different	Yes. Outreach indicates that in most cases entities use official exchange rates that they

	interpretations of the Standard.	technically qualify for in respect of the transaction/net investment being translated, despite the lack of exchangeability. But there are some exceptions.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	Yes, as extending the principle in IAS 21 paragraph 26.	No, because the situation does not meet the current Standard's definition of 'closing rate'.
In addition:		
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (5.17)?	The issue is narrow in scope, but the lack of diversity means that it would not be cost-effective.	The issue relates to specific circumstances, but is broad in nature in that it would represent an exception to the existing principles in IFRS.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	The issue is not being addressed in a forthcoming Standard (although there is a longer-term IASB research project), but the lack of diversity does not justify an interpretation or short-term improvement on its own.	The issue is not being addressed in a forthcoming Standard, but we are unable to resolve it within confines of the current Standard.

Section 2. Additional criteria for annual improvements

In addition to the implementation and maintenance criteria, an AIP should (6.11, 6.12):		
Replace unclear wording	N/A	Not met

Provide missing guidance Correct minor unintended consequences, oversights or conflict		
Not change an existing principle or propose a new principle	N/A	Not met: if not using an exchange rate for immediate delivery at the end of the reporting period, then we would be proposing a new principle.
Not be so fundamental that the IASB will have to meet several times to conclude (6.14)	N/A	Met.

Appendix C—Submission

C1. We received the following request.

IFRS INTERPRETATIONS COMMITTEE

POTENTIAL AGENDA ITEM REQUEST

<u>The issue and current practice:</u>

Various issues related to accounting for entities in Venezuela on consolidation

- Venezuela is a hyperinflationary economy but with strict foreign exchange control remittance rules.
- Due to the foreign exchange controls the impact of hyperinflation is not offset by a corresponding reduction in the exchange rate.
- Until recently there was only one “official” exchange rate. As of March 31, 2014 we are aware of the following “official” exchange rates of the Venezuelan Bolivar (VEF) into USD:
  - CENCOEX: 6.3 VEF/1 USD (fixed-companies importing essential items such as pharmaceutical companies have been informed that this is still the appropriate conversion rate to use although recent remittances, which have been at this rate, are small)
  - SICAD 1: 10.7 VEF/1 USD (variable-for non-essential supplies)
  - SICAD II: 50.85 VEF/1 USD (variable-available for barter transactions but apparently for limited foreign exchange volumes)
- Groups applying IFRS need to follow the rules of IAS 29 and IAS 21 for the translation of the local financial statements which is considered to require the use of «official» exchange rates when producing their consolidated financial statements.
  - Due to the multiple possible exchange rate guidance is required as to the circumstances when the various exchange rates can be used for accounting for the Venezuelan entities in consolidation.

- The application of IAS 29 results in a re-measurement of the local results into units of constant purchasing power. This results in indexing the local results into constant purchasing power VEF at the end of a reporting period. On consolidation, conversion of these inflation-adjusted results into the presentation currency used for consolidation purposes at the IAS 21 required official (fixed) rate of exchange results in an inflation of the results of Venezuela which do not then correspond to the underlying business performance.
    - Guidance is required as to whether there may be circumstances under which inflation adjustments in local financial statements need to be reversed in order to reflect the underlying business performance in the consolidated accounts.
- Furthermore, although local customers are often able to continue paying their invoice, due to the severe exchange controls Group's which supply Venezuela through intercompany shipments are building up local VEF cash balances which would normally be used to pay intercompany purchases. These intercompany balances represent an exchange risk on consolidation. Even though the parent company may consider that a substantial exchange rate devaluation and therefore loss on consolidation is almost virtually certain, application of IAS 21 appears to preclude making a provision for this expected loss.
    - Guidance is required as to whether or not devaluation losses should be recorded in situations where they have in effect occurred. This can be demonstrated based on local price increases, unofficial foreign exchange rates and restrictions to trade at the official rate.

- The current approach is considered to produce unintended and potentially significant distortions when applied for consolidation purposes. We therefore wish to ask the IFRS IC to review the current approach for consolidated financial statements.

Reasons for the IFRS IC to address the issue:

It is considered that the IFRS IC should address this matter as:

- The issue is currently limited to only one country that we know of although it is expected that it could arise in other countries in the near future

- It is pervasive to all entities outside of Venezuela which have operations in the country and that need to produce consolidated financial statements
- There is an urgency to provide guidance on the matters mentioned above so as to rapidly improve the financial reporting for operations in Venezuela

Appendix D— Exchange rate mechanisms in Venezuela

D1. Our understanding is that there are currently the following official exchange rate mechanisms for exchanging the Venezuelan Bolivar Fuerte (VEF):

a. CENCOEX (previously CADIVI): the official fixed exchange rate (6.3VEF/ 1US$) is available to specific industries (companies importing essential supplies) in limited quantities. We have been told that remittances at this rate have been small in practice.

b. SICAD I: a variable rate auction system created in 2013 that is available to entities in specific industry sectors (for non-essential supplies) for a limited volume of VEF. In January 2014 the types of transactions SICAD I could be used for was expanded to include international investment and finance transactions. The average rate achieved in each auction has been published by the Central Bank of Venezuela since December 2013. At 31 March 2014 the SICAD I rate was 10.7 VEF/1 US$.

c. SICAD II: a regulated variable rate system introduced in March 2014 that permits foreign exchange barter transactions in cash and bonds in the private sector with fewer restrictions. The exchange rate has been published daily by the Central Bank. At 31 March 2014 this rate was 50.85 VEF/1 US$. We understand that this mechanism is intended to more closely resemble a market-driven exchange rate; however we have been told that to date there have been limited foreign exchange volumes through SICAD II.