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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 Korea 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);

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

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

APPENDIX A

The KASB's Agenda Proposal for Foreign Currency Accounting

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

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2 December 2011

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

Dear Mr. Hoogervorst,

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

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

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

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

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

> IAS 21 can be improved by providing guidance for rare circumstances. Current requirement of translating foreign currency monetary items at the closing rate (paragraph 23 of IAS 21) should address rare circumstances, in which an alternative rate to the closing rate should be required or permitted. It is appropriate to use the closing rate as far as the closing rate reflects the market's best estimate of future events that affect the currency, considering an analogy to paragraph BCZ47 of the Basis for Conclusions on IAS 36 *Impairment of Assets*.
>
> However, in our view, using the closing rate in rare circumstances would not be appropriate since the closing rate does not reflect the market's best estimate of future events in such circumstances. Rare circumstances are the cases where all of the following conditions are met: i) Foreign exchange market classified as a "thin market", ii) Significant exchange rate fluctuation due to exceptional and temporary external shocks such as financial crises, and iii) Long-term foreign currency items.

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

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

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

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

Yours sincerely,

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

Cc: Sungsoo Kwon, Senior Director of Research Department

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

Summary

I. Background

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

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

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

III. Overall Direction of the Research

- Using the closing rate per se cannot be a principle
- More basic principle: The rate should reflect the best estimate of the future rate at the time of receipt or settlement of foreign currency monetary items
  - ✓ Analogised to the Basis of Conclusions[1] in IAS 36, *Impairment of Assets*[2]

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

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

BCZ46 In response to comments from field test participants, paragraph 54 of IAS 36 includes guidance on calculating the value in use of an asset that generates future cash flows in a foreign currency. IAS 36 indicates that value in use in a foreign currency is translated into the reporting currency[2] using the spot exchange rate at the balance sheet date.

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

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

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

IV. Proposal

- Add requirements addressing rare circumstances where the closing rate does not represent the best estimate
- Limited scope amendment
  - ✓ Complement to the principles in IAS 21
- Rare circumstances should be limited to the cases where all of the following conditions are met:
  - ✓ Foreign exchange market classified as a "thin market"[3]
  - ✓ Significant exchange rate fluctuation due to exceptional and temporary external shocks such as financial crises[4], and
  - ✓ Long-term foreign currency items[5]
- Apply the alternative rate that replaces the closing rate in rare circumstances
  - ✓ Adjusted historical rate model: the exchange rate using a long term trend line obtained from historical data (e.g. moving average rate)
  - ✓ Expected rate model: the exchange rate that represents the normal rate over the long-term, reflecting the best estimate of future events

V. To be discussed further

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

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

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

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

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

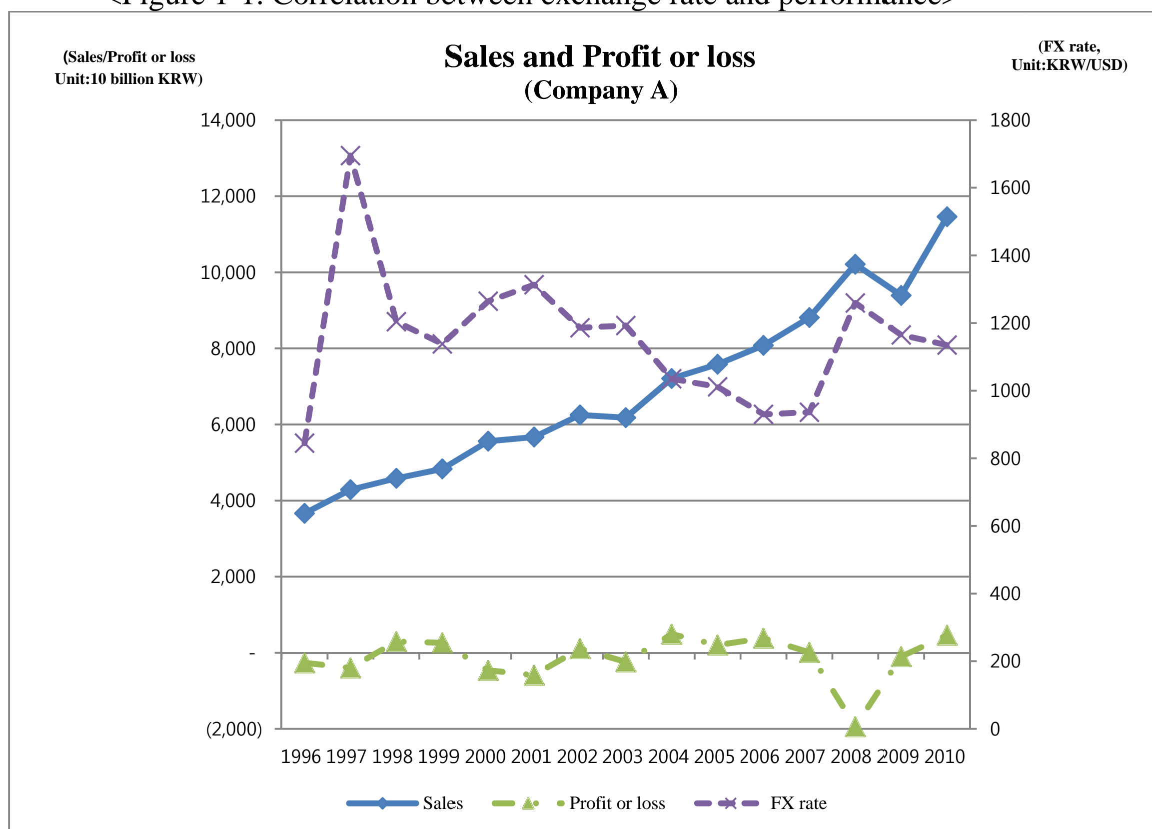
I. Background

Entities Raising Issues in Times of Financial Crises

1.1 Entities encounter unexpected difficulties due to the increased volatility of the foreign exchange market that is often compounded by financial crises.

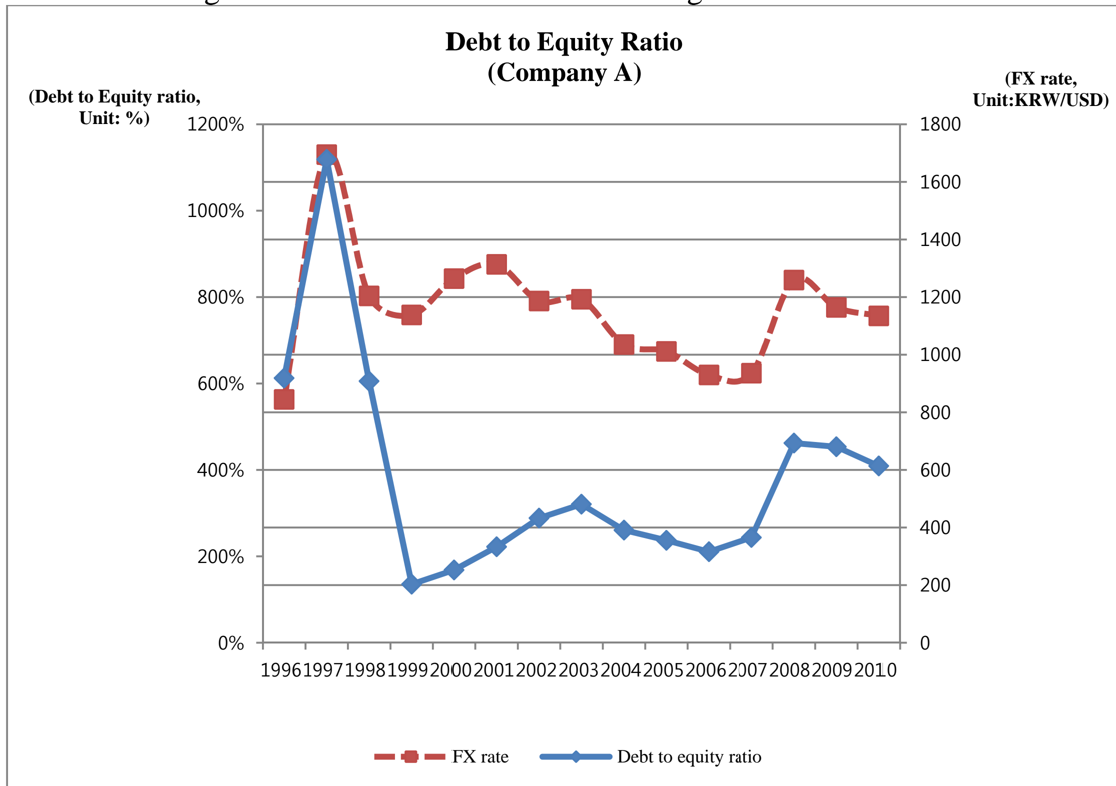
1.2 In particular, one of the most recurring, controversial accounting issues that emerging economies raise in times of such crises is the requirement to translate foreign currency monetary items at the closing rate. The argument against this requirement is that applying the closing rate which is determined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

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



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

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



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

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

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

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

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

[7] In IAS 21, closing rate is defined as 'the spot exchange rate at the end of the reporting period'.

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

1.7 Admittedly, closing rates from "active markets", in most cases, would represent the best estimate of future events that will affect the currency since most active markets are presumably deep[8]. However, as shown above, it would prove otherwise when there are structural deficiencies in the foreign exchange market (e.g. "thin market") and external shocks such as the financial crises although such cases may be rare. Thus we believe that the IASB needs to provide requirements addressing the rare cases.

1.8 The following section of this report describes the rare cases more in detail where the closing rate does not represent the best estimate of future events and proposes to add requirements as to such cases. Further, it explores alternative exchange rates that can represent the best estimate of future events instead of the closing rate when using the closing rate is inappropriate.

1.9 This report, however, does not include sufficient review over the microstructure of foreign exchange market from the perspective of economics, so that future study will be necessary in cooperation with economists. Also further study should be undertaken as to what characteristics are required of alternative exchange rates to replace the closing rate.

1.10 The following section (II. Proposal) sets out the need for adoption of foreign currency accounting as one of the IASB future agendas and the proposal of alternatives to closing rate by using the criteria for agenda setting included in the IASB Due Process Handbook.

II. Proposal

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

2.1 Criterion 1 considers whether the project addresses the needs of users across different jurisdictions. The criterion considers the following factors:

(a) Changes in financial reporting and regulatory environment: international relevance
(b) pervasiveness

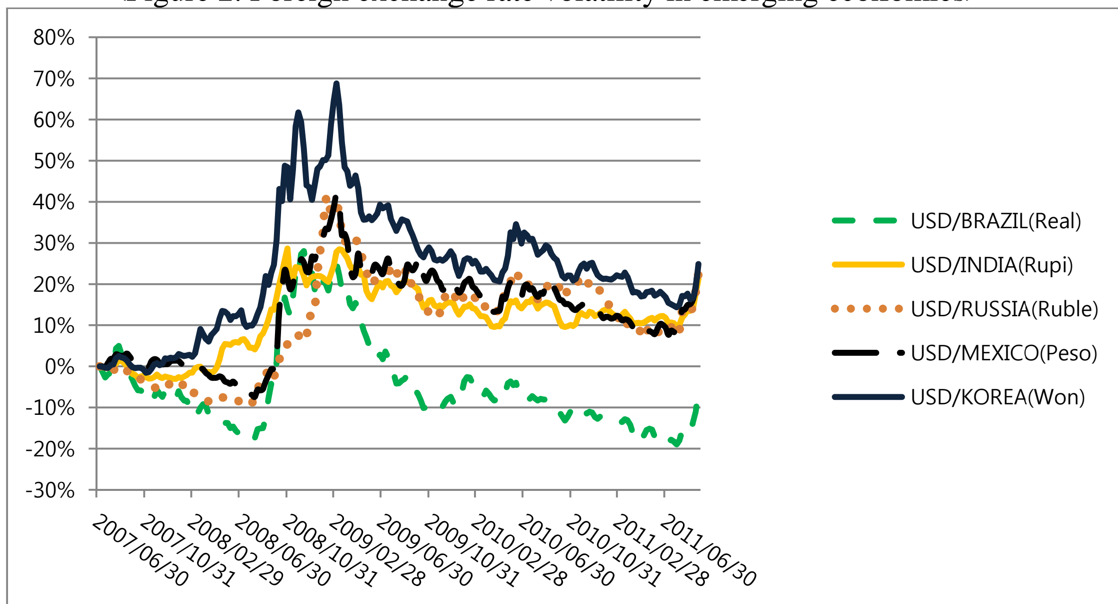
[8] In this report, the concept of active market includes both thin and deep markets and it is viewed that the closing rate would represent the best estimate of future events in deep and active markets.

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

International relevance

2.2 Foreign currency accounting has been considered as very important to entities in emerging economies. It is drawing even greater attention as many emerging economies, including Brazil, India, Korea, Mexico, and Russia, adopted the floating exchange rate system after they weathered the Asian Financial Crisis in the late 1990s and the foreign exchange rate volatility is growing larger[9] as a result of the adoption (Figure 2).

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



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

2.4 Considering the issues raised by emerging economies are only relevant to the times of financial crises, the IASB needs to focus on examining whether it can require or permit a special accounting treatment in times of financial crises.

Pervasiveness

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

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

Urgency

2.6 It would be reasonable to consider foreign currency accounting as one of the "Financial Crisis Project" of the IASB. The IASB has initiated and is currently carrying out the "Financial Crisis Project" to address a number of urgent accounting issues raised by stakeholders during the "financial crisis." The project includes topics such as comprehensive review of "Financial Instruments" including a proposal to change the impairment principle from 'incurred loss model' to 'expected loss model', 'off-balance sheet financing', and 'fair value measurement', and etc.

2.7 While these topics are clearly important to entities in emerging economies, the most challenging topic of all for emerging countries during the "financial crisis" has been "foreign currency accounting." Considering this, "foreign currency accounting" should be addressed on the same footing as other topics in the "Financial Crisis Project."

2.8 Furthermore, the fact that the IASB amended IFRS in 2008 to allow a different accounting treatment in times of financial crises[10], which is to permit an item measured at fair value to be measured at amortised cost, suggests that it may be reasonable to examine the alternative that provides a different accounting treatment for foreign currency accounting in times of financial crises.

2.9 In particular, the IASB implicitly defines "financial crisis" as "a single event which is very unlikely to recur within a short period of time" in the 2008 amendment mentioned above. Considering this in relation to long-term foreign currency monetary items, it may be viewed as that a rate change caused by a short-term event of "financial crisis" is very unlikely to affect long-term items at the time of settlement. This is so because the unusual effect induced by such single event will fade away over the long-term. Thus, reflecting such short-term effect on long-term items in profit or loss in the period in which the event occurred would not show the performance of the entity in an adequate manner.

2.10 Meanwhile, instability of foreign exchange rate is expected to grow even greater due to the ever increasing international capital flows. Therefore, a situation similar to the

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

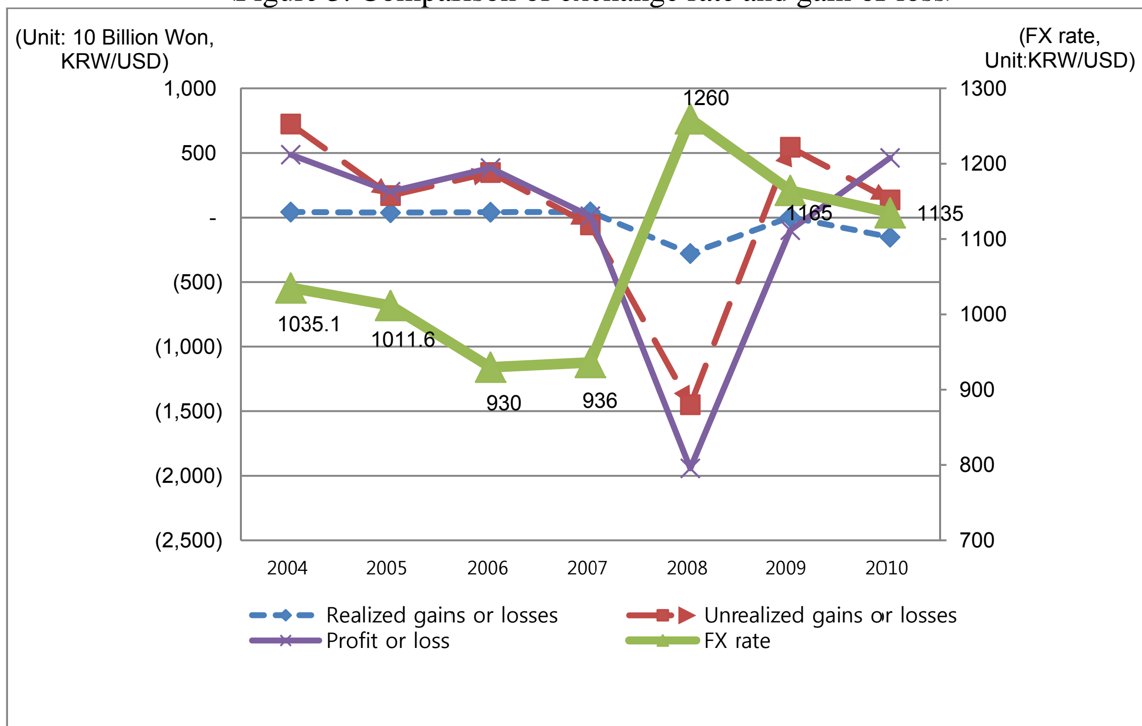
"financial crisis" of 2008 may arise in the near future. Under such a "financial crisis" circumstance, the demand for amendment of "foreign currency accounting" from emerging economies is likely to intensify. Thus, the issue of "foreign currency accounting" should be addressed before such intensification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

Consequences

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

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

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



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

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

Criterion 2: Existing guidance available

2.13 Criterion 2 considers whether the project will address an area on which the existing guidance is insufficient.

2.14 While IAS 21 requires foreign currency monetary items to be translated at the "closing rate" and the resulting translation gain or loss to be reflected in profit or loss for the period, it does not consider any exceptions.

2.15 However, if the proposal in this report is followed (refer to Availability of alternative solutions in Criterion 3), a rate other than the closing rate would have to be used when unusual events such as financial crises occur in a market in which the "closing rate" cannot reflect the best estimate of the future events, e.g., a thin market.

2.16 Therefore, guidance should be provided regarding the characteristics of the market in which the "closing rate" cannot reflect the best estimate of the future events; conditions for unusual events such as financial crises; and the method to calculate an alternative rate that can replace the "closing rate".

Criterion 3: The possibility of increasing convergence

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

Criterion 4: The Quality of the IFRSs to be developed

2.18 Criterion 4 considers the qualitative aspects of the standards that are proposed to be developed. This criterion considers the following factors:

(a) availability of alternative solutions
(b) cost/benefit considerations
(c) feasibility

Availability of alternative solutions

2.19 As described in Criterion 1, the most efficient way for the IASB to address the issues raised by emerging economies is to first examine whether a different accounting treatment is needed for foreign currency monetary items in times of "financial crises" and if so what alternatives are available.

2.20 Our proposal, in short, is that another exchange rate rather than the closing exchange rate should be permitted to be used when the closing exchange rate is unable to reflect the best estimate for future events in unusual circumstances such as the "financial crises". The basis and details of this proposal are provided in the following paragraphs.

2.21 IAS 21 defines the "closing rate" as the "spot exchange rate at the ends of reporting

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

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

2.22 The reason for translating foreign currency monetary items at the spot rate at the ends of reporting periods may be explained as that the spot rate reflects the best estimate of the rate at the time of future settlement of the foreign currency monetary items[12]. What should be additionally considered at this point, however, is when unusual events such as the "financial crises" arise. There are doubts as to viewing the spot rate which fluctuated significantly during such an unusual event as the best estimate of the exchange rate at the time of future settlement.

2.23 Admittedly, when "a currency is freely convertible and traded in an active market," it would be rational to regard the spot rate as the best estimate of the exchange rate at the time of future settlement even if events of a "financial crisis" occur. This may be so because such a market would be an efficient market and thus the impact of a single event of "financial crisis" on rate fluctuation would be relatively small. However, when "a currency is not freely convertible and not traded in an active market," the impact of a single event of "financial crisis" on rate fluctuation would be relatively large and thus the spot rate may not reflect the market's best estimate at the time of future settlement.

2.24 IAS 36 requires that the spot rate be used even when the spot rate does not reflect the market's best estimate of future events because entities are less likely to make a more reliable estimate of future exchange rates than the current spot rate[13].

2.25 However, the IASB does not seem to have considered the unusual cases of "financial crises" when they reached this conclusion[14]. Thus, considering the "financial crises" situations, review should be carried out regarding whether another rate can provide a more reliable estimate when the spot rate is unable to reflect the market's best estimate

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

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

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

of future events.

2.26 Meanwhile, it should be noted that the subject to which alternative rate would be applied is limited to long-term items rather than entire foreign currency monetary items including short-term items. Since unusual circumstances such as the “financial crises” require a certain period of time before being resolved, it would be rational to apply the closing rate for short-term items without exception.

2.27 While there should also be discussion about how to distinguish between short-term and long-term items, making this distinction consistent with that specified in IAS 1 for financial statement presentation would be the most reasonable method to enhance consistency and reduce complexity across the standards.

2.28 The proposal in short is that there is a need to review alternative rates to replace the closing rate (i.e. spot rate) when the closing rate is unable to reflect the market’s best estimate in unusual circumstances of “financial crises”. Furthermore, the subject to which the alternative rates are to be applied is long-term foreign currency monetary items. This is summarized in Table 1 below.

<Table 1: Areas requiring review in IAS 21>

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

2.29 In carrying out the review required as above, the following should be examined to provide possible alternatives.

- Step 1: Define the market where the closing rate is unable to reflect the market’s best estimate of future events
- Step 2: Determine unusual circumstances such as the “financial crises”
- Step 3: Determine alternative exchange rates which can replace the closing rate

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

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

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

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

2.31 According to the definition, the foreign exchange market of a country that adopted the floating exchange rate system would generally fall into the category of "active market" by definition. The question, however, is that whether the case where the spot rate is unable to reflect the market's best estimate of future events would arise only when the currency is not traded in an "active market" in accordance with the definition in IAS 39.

2.32 IAS 19 may be referred to regarding this issue. IAS 19 requires the return of corporate bonds to be used as the discount rate for discounting post-employment benefit payables when the corporate bond market is a deep market. An assumption is likely to be inherent in this requirement that the return of corporate bonds in a market that is not deep is unable to reflect the best estimate of the liability at the time of settling post-employment benefit payables in the future.

2.33 Thus, by analogy, the concept of "deep market" in IAS 19 could be used to the foreign exchange market[15]. "Thin market," as opposed to "deep market," is defined in a number of papers on the microstructure of foreign exchange market, and these papers analyse the movement of the exchange rates in thin markets based on the properties of thin market. "Thin market" is described in several papers as cited in the following paragraphs.

2.34 One report[16] utilizes the "turnover of foreign exchange market activity compared to GDP" as an indicator for the "thin market". This report analyses the nations heavily affected by the Asian Financial Crisis in 1997, e.g., Indonesia, Thailand, Malaysia, and Korea, and cites their foreign exchange markets having been "thin markets" as the main reason for their failure to stop the herding behavior of investors which led to the skyrocketing foreign exchange rates[17].

2.35 Another way to define a "thin market" includes using the number and characteristics of market participants. For example, if there are limits as to market participants and the role of government is significant among the market participants, it is analysed that the foreign exchange market would not be deep and competitive. Furthermore, in such thin

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

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

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

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

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

market, the volatility would increase if the floating foreign exchange rate system is implemented[18].

2.36 These studies indicate that when foreign exchange markets display the characteristics of "thin market," the spot rate in such markets may not represent the best estimate of future events.

2.37 Furthermore, it should be noted that the micro-structural analysis of "thin market" can effectively explain a short-term situation like the "financial crises". The micro-structural factor of market can adequately explain the movement of exchange rates in the short term while other theories of foreign exchange rate movement like macroeconomic fundamentals or random walk model are less likely to do so[19].

2.38 The foreign currency accounting project should utilize the studies in the field of economics on the microstructure of the foreign exchange markets and develop concrete bases for identifying what constitutes a "thin market" in the future.

Step 2: Determine unusual circumstances such as the "financial crises"

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

2008 amendment to IAS 39

2.40 It may be helpful to first consider the IASB's 2008 amendment to IAS 39 for reclassification of financial instruments. As described above, in that amendment, the IASB implicitly referred to a situation like the "financial crisis" as "rare circumstance" and "a single event that is unusual and highly unlikely to recur in the near term" when they amended IAS 39 to permit an item measured at fair value to be measured at amortised cost in 2008.

2.41 However, it would not be adequate to define unusual circumstances for foreign currency accounting in the same way as the 2008 amendment. It is our view that the description in the 2008 amendment is too broad to serve as indicators by which an entity assesses whether an unusual circumstance has occurred in the foreign currency market.

IFRS 13, Fair Value Measurement

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

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

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

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

2.43 Not much effort has been made to develop potential indicators as yet, but it would be reasonable to base the discussion over this matter upon the same concreteness and rigor as required in IFRS 13.

2.44 Meanwhile, some may raise a concern about determining when unusual circumstances disappear and the markets become normal again because once it is reversed, it is necessary to re-use the closing rate instead of the alternative rate, from the point of time when the unusual circumstances cease to exist.

2.45 The concern, however, may not lead to a critical issue if concrete and clear indicators are provided for determining when unusual circumstances begin. This is because it would be sufficient to resolve such concern by prescribing a requirement such that reverse changes in indications for the occurrence of unusual circumstances shall mark the end of unusual circumstances. Such requirement will then make it unnecessary to consider separate indicators for determining when unusual circumstances disappear. This logic is also consistent with the way in which IAS 36 provides indicators for reversal of impairment loss; IAS 36 prescribes the cases that indicate reversal of impairment loss by mirroring the cases that indicate incurrence of impairment loss.[20]

2.46 Some others may point out another issue related to the end of unusual circumstances; that is, when an unusual circumstance ceases to exist, how an entity should account for cumulative exchange difference between the amounts resulting from translating at an alternative rate and the amounts that would otherwise have been resulted from translating at the closing rate during the period of unusual circumstances.

2.47 However, according to our proposal, there should not be any such cumulative exchange difference. Only change that would be brought in by our proposal is that an alternative rate replaces the closing rate during the period of unusual circumstances. In other words, the exchange difference resulting from translating at the alternative rate will be recognised in profit or loss as well. Therefore, even when unusual circumstances turn normal again, there will be no need to consider any exchange difference in a different manner for that period.

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

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

Alternative 1: Adjusted historical rate model

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

2.49 The first alternative is to utilize the long-term trend rate calculated by using historical rate data when an event like the "financial crisis" arises. For example, a historical rate adjusted by the long-term trend line may be used or a moving average rate may be used.

2.50 Reliability of this alternative would be relatively high compared to the alternative 2 below because it is based on objective data. Moreover, this alternative would be able to reflect better estimate of future events than the spot rate in times of "financial crises" since long-term items reflect the long-term trend line of exchange rates.

Alternative 2: Expected rate model

2.51 The alternative 2 is to use the expected exchange rate that reflects the best estimate at the time of settlement of long-term monetary items. One example would be to calculate an expected rate on each item by extending the long-term trend line of exchange rate to the expected settlement date. Another example would be to calculate an econometrically forecasted rate at the balance sheet date by using macroeconomic variables. The expected rate model should be reviewed in detail from the economic point of view regarding how to calculate the expected rate and also whether such expected rate may be a more rational alternative than the closing rate.

2.52 The alternative 1 may be more reliable since it uses past rate data but its relevance as a future estimate may be weak. Therefore, if the expected rate, excluding the rate fluctuations caused by the effect of the "financial crises," can be estimated with reliability, then the second alternative may be more appropriate than the alternative 1 above.

2.53 This alternative using an expected rate would also be adequate in the context of the IASB's current direction for amendment of financial instrument impairment in IAS 39. Although the existing IAS 39 specifies to recognize an impairment loss when an impairment event arises ("incurred loss model"), the current direction for amendment is to recognize an impairment loss based on expected future cash flows ("expected loss model"). Thus, using the closing rate and using the expected rate may be likened to the "incurred loss model" and the "expected loss model", respectively. Using the closing rate is akin to the "incurred loss model" in that it considers an event that have already occurred, and using the expected rate is analogous to the "expected loss model" in that it considers expected future cash flows at the time of settlement of long-term items. .

Criticisms over the alternatives

2.54 There may be criticisms against the alternatives provided herein. Proponents of the criticisms argue that even if an event like the "financial crisis" arises in a "thin market," there would be no better estimate than the closing rate if the closing rate reflects recent transactions in the foreign exchange market.

2.55 We believe, however, such criticisms are defective in that they regard the concept of best estimate the same as the concept of fair value. These two concepts are conceptually different from each other. The criticisms would be valid if the purpose of translation is to measure fair value. In other words, from the perspective of fair value measurement, an item should be measured at a price reasonably exchangeable between the parties on

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

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

Cost/benefit considerations

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

Feasibility

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

Criterion 5: Resource constraints

2.59 Criterion 5 considers whether there are sufficient resources to undertake the project. The criterion considers the following factors:

(a) availability of expertise outside the IASB
(b) amount of additional research required
(c) availability of resources

2.60 Foreign currency accounting has been frequently discussed in advanced countries in the past and thus there should be a large number of experts available outside the IASB. Furthermore, the foreign currency accounting working group made up of NSSs should be able to provide the resources necessary when the IASB carries out the project.

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

<u>Background</u>

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.

<u>Objective</u>

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

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[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.

[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.