

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 21 — Foreign exchange restrictions		
Paper topic	Initial consideration		
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<p>This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee). Comments on the application IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (Board) can make such a determination. Decisions made by the Committee are reported in IFRIC® <i>Update</i>. The approval of a final Interpretation by the Board is reported in IASB® <i>Update</i>.</p>			

Introduction

1. We have been made aware of application difficulties that have arisen in identifying the exchange rate to use when applying IAS 21 *The Effects of Changes in Foreign Exchange Rates* in the following circumstances (which we refer to as the ‘matter’ throughout this paper):
 - (a) a reporting entity translates the results and financial position of a foreign operation into its presentation currency; and
 - (b) the functional currency of the foreign operation is subject to a longer-term lack of exchangeability with other currencies.
2. These circumstances exist in Venezuela.
3. The IFRS Interpretations Committee (Committee) discussed these circumstances in the past. In November 2014, the Committee decided not to add to its agenda the matter of which exchange rate to use when there is a longer-term lack of exchangeability of a currency. The Committee considered the matter too broad in scope for it to address.
4. Stakeholders have informed us that recent developments in Venezuela have increased the severity of the matter. Those stakeholders indicated that the official exchange rate of the Venezuelan Bolivar (VEF) does not faithfully represent the economic

circumstances prevailing in Venezuela and could not reasonably be used in applying IAS 21 to the financial statements of foreign operations with a functional currency of VEF. Those stakeholders also indicated that diversity in reporting practices has arisen.

5. We have investigated the matter further and undertook outreach activities with some preparers (entities), auditors and regulators to help the Committee:
 - (a) understand the severity of the matter and the diversity in reporting practices; and
 - (b) assess how the Committee might address the matter.
6. The objective of this paper is to:
 - (a) provide the Committee with a summary of the matter;
 - (b) present our research and analysis; and
 - (c) seek the Committee's preliminary views on the matter.
7. This paper does not ask the Committee to make any decisions. We think it would be helpful for the Committee to first discuss the matter before we then recommend a way forward, having considered the Committee's initial discussion. We would plan to bring a paper to the June 2018 Committee meeting that would include a recommendation for the Committee's consideration.

Structure of the paper

8. This paper is structured as follows:
 - (a) Background information (paragraphs 10-16);
 - (b) Summary of staff research (paragraphs 17-20);
 - (c) Staff analysis of the matter (paragraphs 21-55);
 - (d) Possible ways to address the matter (paragraphs 56-66); and
 - (e) Staff preliminary view (paragraphs 67-70).

9. This paper has four appendices:
- (a) Appendix A – Extract from November 2014 *IFRIC Update*;
 - (b) Appendix B – Detailed summary of staff research;
 - (c) Appendix C – Discussion of the matter when the functional currency of a foreign operation is the currency of a hyperinflationary economy; and
 - (d) Appendix D – Inflation and exchange rate (educational material).

Background information

10. IAS 21 does not include any specific requirement on the exchange rate a reporting entity uses to translate the results and financial position of a foreign operation¹ when there is a longer-term lack of exchangeability between (i) the functional currency of the foreign operation and (ii) the presentation currency of the reporting entity.
11. We were recently informed about the application of IAS 21 in relation to foreign operations in Venezuela, and in particular the exchange rate used to translate the results and financial position of those foreign operations into a reporting entity's presentation currency. Some stakeholders explained that:
- (a) the matter has become particularly extreme for Venezuelan foreign operations, whose functional currency is VEF. In particular:
 - (i) entities have been unable for several years to exchange VEF to repatriate dividends or make investment-related payments².
The exchangeability of VEF, limited in previous years, has been significantly reduced over the past year;

¹ Paragraph 8 of IAS 21 defines a foreign operation as an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

² We refer to the definition that the International Monetary Fund provides for 'investment-related payment' ie 'profits and dividends, interest payments (including interest on debentures, mortgages, etc.), amortization of loans or depreciation of foreign direct investments, and payments and transfers of rent'. This definition can be found in the *2016 Annual Report on Exchange Arrangements and Exchange Restrictions* available [here](#).

- (ii) the official exchange rates³ for VEF are not free-floating rates—the jurisdictional authorities fix those rates and have adjusted them but only sporadically, and the adjustments have not faithfully reflected the prevailing hyperinflationary⁴ conditions;
- (iii) the lack of exchangeability of VEF with other currencies has increased the disconnect between the official exchange rates of that currency and the inflation rate in Venezuela;
- (iv) the use of the official exchange rates to translate the financial statements of Venezuelan foreign operations results in overstating the relative share of those foreign operations in the total assets, liabilities, equity, income and expense of the entity;
- (v) this overstatement can lead to material distortions in the financial statements of an entity. For example, translating cash and cash equivalent balances using an official exchange rate results in reporting cash and cash equivalent amounts that could not practically be exchanged at this rate, overstating the reported amounts; and
- (vi) the application of IAS 29 *Financial Reporting in Hyperinflationary Economies* has exacerbated the distortions described above. In particular, IAS 29 requires an entity to:
 1. restate non-monetary assets and liabilities of the Venezuelan foreign operations—denominated in VEF—to reflect inflation (ie applying a general price index). However, if using the official exchange rates to translate the restated amounts into the entity’s presentation currency, an entity then translates the restated amounts using an exchange rate that does not reflect the inflation rate

³ As at 31 December 2017, there were two official exchange rate mechanisms in Venezuela for buying or selling VEF against foreign currencies (‘DIPRO’ and ‘DICOM’). In January 2018, a new exchange system was introduced. This new system removed the DIPRO rate and introduced a new DICOM rate. Throughout this paper, we mention the existence of several exchange rates because we conducted our outreach activities in 2017 ie at a time at which there were 2 exchange rates. The 2018 monetary reform does not affect our analysis because this paper does not discuss the application of IAS 21 when there are multiple exchange rates for a currency.

⁴ We understand that Venezuela is considered to be a hyperinflationary economy as defined by IAS 29 *Financial Reporting in Hyperinflationary Economies*.

prevailing in Venezuela. The disconnect between the inflation rate and the official exchange rates results in an overstatement of reported non-monetary assets and liabilities, which increases over time;

2. compute a gain or loss on the net monetary position of the Venezuelan foreign operation—denominated in VEF, which the entity translates into its presentation currency applying IAS 21. The gain or loss may be overstated if the exchange rate used has not been adjusted to reflect inflation;
3. restate all amounts included in the statement of comprehensive income of the foreign operation—denominated in VEF—to reflect inflation. Individual line items (such as revenue and profit/loss for the period) in the statement of profit or loss may also be overstated when translated into the entity's presentation currency.

Appendix C to this paper illustrates the possible distortions described in this paragraph.

- (b) diversity in reporting practices has arisen with respect to Venezuelan operations. Our research has identified three main reporting practices:
 - (i) the use of one of the official exchange rates;
 - (ii) the use of an estimated exchange rate, adjusted to reflect inflation in Venezuela; and
 - (iii) the deconsolidation of Venezuelan foreign operations.
12. Irrespective of the reporting practice applied, some entities have explained the effects of the matter in the notes to their financial statements or by presenting specific financial information in their management commentary.

Previous consideration of the matter by the Committee

13. The Committee received a request in 2014 asking about the translation and consolidation of the results and financial position of Venezuelan foreign operations. At that time, the Committee discussed the longer-term lack of exchangeability

between (i) the functional currency of the foreign operation and (ii) the presentation currency of the entity⁵.

14. In November 2014, the Committee decided not to add this matter to its agenda. The Committee's Agenda Decision (see Appendix A to this paper) states:

...[The Committee] observed that a longer-term lack of exchangeability is not addressed by the guidance in IAS 21, and so it is not entirely clear how IAS 21 applies in such situations. However, the [Committee] thought that addressing this issue is a broader-scope project than it could address. Accordingly, the Interpretations Committee decided not to take this issue onto its agenda...

15. The Committee also noted within the Agenda Decision that several disclosure requirements would apply when the effect of foreign exchange controls is material to understanding an entity's financial performance and position.

Previous consideration of the matter by the Board

16. Several respondents referred to this matter in responding to the Board's 2015 Agenda Consultation. The Board considered those comments in May 2016, and decided not to add to its work plan a project on foreign currency translation.

Summary of staff research

17. In order to gather information on, and gain a better understanding of, the matter, we:
- (a) reviewed the IFRS financial statements of twenty entities that described the accounting for their Venezuelan foreign operations. Specifically we

⁵ At that time, the submitter described various matters affecting VEF, including the existence of:

- (a) several official exchange rates that may not reflect the local rate of hyperinflation, and
- (b) restrictions over the amount of local currency that can be exchanged.

Accordingly, the Committee identified two accounting matters:

- (a) which rate should an entity use to translate its net investment in the foreign operation when there are multiple exchange rates?

- (b) which rate should an entity use when there is a longer-term lack of exchangeability?

This paper discusses only the second of those matters. The Agenda Decision published by the Committee in 2014 includes some explanatory information regarding the first matter (see Appendix A to this paper).

reviewed the financial statements of those entities for annual periods ending in 2016. We also investigated whether those entities subsequently changed their reporting practices by reviewing interim reports published for the 2017 financial year⁶;

- (b) surveyed a sample of entities with Venezuelan operations, using a questionnaire to gain an in-depth understanding of the reporting practices. We specifically sought feedback on:

- (i) which exchange rate the entity applied in translating the results and financial position of Venezuelan foreign operations; and
- (ii) if an estimated exchange rate was used, how the entity estimated such a rate.

18. Our research identified that:

- (a) the matter already has a material effect for some entities and may result in a material effect for others in the near term; and
- (b) there is diversity in reporting practices (as mentioned above in paragraph 11(b) of this paper).

19. Appendix B to this paper details the findings of our research.

20. Venezuela is, to the best of our knowledge, the only jurisdiction for which the matter discussed in this paper arises. We are aware that the currencies of some other jurisdictions face exchangeability restrictions. However, we understand that those restrictions:

- (a) arise from circumstances that are different from the specific set of circumstances in Venezuela and do not result in a longer-term lack of exchangeability to the extent experienced in Venezuela; and
- (b) may affect jurisdictions within which IFRS entities have no significant foreign operations.

⁶ We did not review financial statements as at 31 December 2017 because only some of the entities we surveyed had released their annual financial statements on the date at which this paper was written.

Staff analysis

What does IAS 21 say?

Translation to the presentation currency

21. Paragraph 18 of IAS 21 specifies that a reporting entity translates the results and financial position of each individual entity included in the reporting entity into the currency in which the reporting entity presents its financial statements. Those requirements apply to any foreign operation of the reporting entity.
22. Paragraphs 39 and 42 of IAS 21 specify that an entity translates:
 - (a) the assets and liabilities of the foreign operation using the ‘closing rate’;
and
 - (b) income and expenses of the foreign operation using:
 - (i) the ‘exchange rates at the dates of the transactions’ if the functional currency of the foreign operation is not the currency of a hyperinflationary economy; or otherwise
 - (ii) the ‘closing rate’⁷.

What is the closing rate?

23. Paragraph 8 of IAS 21 includes the following definitions:

...Exchange rate is the ratio of exchange for two currencies...

...Closing rate is the spot exchange rate at the end of the reporting period...

...Spot exchange rate is the exchange rate for immediate delivery.
24. IAS 21 does not specify any particular exchange rate as the spot exchange rate. We understand most entities use the ‘dividend remittance rate’ or, more generally, the exchange rate that would apply to investment-related payments (‘investment-related

⁷ Unless otherwise stated and to simplify the analysis, this paper discusses the determination of the ‘closing rate’. We note that the analysis would be unchanged in determining the ‘exchange rate at the dates of the transactions’.

remittance rate’) to translate the results and financial position of foreign operations into the presentation currency.

Does IAS 21 address circumstances in which a currency is not exchangeable?

25. Paragraph 26 of IAS 21 includes requirements that apply when the exchangeability between two currencies is *temporarily* lacking. These requirements apply when exchangeability is temporarily lacking between the foreign currency in which a transaction is denominated and an entity’s functional currency (ie the requirements are not included in the section of IAS 21 that addresses translation into an entity’s presentation currency). Paragraph 26 of IAS 21 states (emphasis added):

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

26. IAS 21 does not say anything further about a temporary lack of exchangeability.
27. In addition, IAS 21 does not include any requirements for circumstances in which there is a longer-term lack of exchangeability (ie a lack of exchangeability that is other-than-temporary).

Should the Committee reconsider the matter?

Exploring whether the Committee could help stakeholders reach a common understanding of the requirements in IAS 21 in this situation

28. Stakeholders with whom we discussed this matter are of the view that IAS 21 does not address it specifically. By stating that it is not entirely clear how IAS 21 would apply in the circumstances in which the matter arises, the Committee’s Agenda Decision published in November 2014 supported this view. The Committee did not provide any explanatory material in that Agenda Decision on the matter. Accordingly, entities acting in good faith have selected and applied an accounting policy to their Venezuelan foreign operations. As explained in paragraph 18 of this paper, this has resulted in diversity in reporting practices. Stakeholders highlighted that recent developments in Venezuela have exacerbated the matter.

29. In our view, the Committee should reconsider the matter and reassess whether it might be able to provide explanatory material that would help entities in applying IAS 21, or otherwise consider whether narrow-scope standard-setting might be appropriate. We have outlined in paragraphs 31-55 below our analysis of the application of the requirements in IAS 21.

Avoiding application of an estimated exchange rate to wider circumstances not considered by the Committee

30. We think the matter discussed in this paper raises two other matters with wider implications. These matters are:
- (a) the circumstances in which it is appropriate to use an estimated exchange rate when applying IAS 21 rather than, for example, an official exchange rate set by jurisdictional authorities that manage the exchangeability of a currency. In our research, some stakeholders mentioned that changes in an exchange rate used in applying IAS 21 should *always*, in their view, reflect the change in prices ie inflation, and thus an entity might estimate the exchange rate to be used to reflect inflation in circumstances beyond those discussed in this paper. Although we agree that there is a well-established relationship between inflation and exchange rates (see Appendix D to this paper), we think the requirements in IAS 21 do not necessarily support this view expressed by some stakeholders. In our view, there might be circumstances in which the spot exchange rate (as defined in IAS 21—see paragraph 23 of this paper) might not reflect inflation in a precise manner. As explained in paragraph 48 below, we think an entity would use an estimated exchange rate *only* when an exchange rate for immediate delivery is not observable and thus the entity needs to estimate the spot exchange rate.
 - (b) the possible inappropriate use of the conclusion in the 2014 Agenda Decision in other circumstances. We understand that several currencies are facing exchangeability difficulties. Those difficulties arise from circumstances that are different from the specific set of circumstances in Venezuela and do not result in a longer-term lack of exchangeability to the

extent experienced in Venezuela. Accordingly, determining how an entity might apply IAS 21 in those circumstances would require a thorough analysis, which may not be the same as the analysis in relation to Venezuelan foreign operations. In other words, we think there is a risk that the conclusion the Committee reached in 2014 in relation to Venezuela might be read as permitting the use of an estimated exchange rate in other circumstances, which may not be appropriate. For this reason, we see benefit in exploring whether the Committee could specify the circumstances that exist in Venezuela to avoid the risk of inappropriate application of any conclusion relating to Venezuelan foreign operations.

Staff analysis of the matter

What are the main features of the closing rate as defined in IAS 21?

31. As mentioned above, IAS 21 defines the closing rate as ‘the spot exchange rate at the end of the reporting period’. The spot exchange rate is ‘the exchange rate for immediate delivery’.
32. In the light of these definitions, we think the closing rate is the rate that would apply if one currency were to be exchanged at the end of the reporting period for another currency with immediate delivery.
33. Paragraph 26 of IAS 21 confirms this view. In describing the closing rate (in the context of translating foreign currency amounts into an entity’s functional currency), paragraph 26 states (emphasis added):

When several exchange rates are available, **the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date...**⁸

34. We also think the closing rate is a rate that is available to an entity through a legal exchange mechanism at the reporting date. ‘Immediate delivery’ implies an entity

⁸ In considering paragraph 23 of IAS 21, we think the rate to which this sentence refers can be (i) the closing rate; (ii) the rate at the date of a transaction; or (iii) the rate at the date when fair value is measured.

must have immediate access to an exchange mechanism. There are typically two broad categories of legal exchange mechanisms available to an entity:

- (a) a financial market (in the case of free market exchangeability); or
- (b) an administrated process created and directed by jurisdictional authorities –
– what we call ‘administrated exchangeability’ in this paper ie the jurisdictional authorities buy and sell foreign currencies and are responsible for allocating those currencies to entities and individuals in the jurisdiction.

What is a longer-term lack of exchangeability?

A lack of exchangeability

- 35. In our view, a lack of exchangeability arises if an entity is unable to exchange a currency for another currency through a legal exchange mechanism.
- 36. In the case of administrated exchangeability, foreign currency restrictions might prevent an entity from buying foreign currency or limit its ability to do so. Accordingly, those restrictions might create a lack of exchangeability. The fact that jurisdictional authorities might set an official exchange rate is not necessarily evidence that the currency is exchangeable. In such circumstances, the key question is whether a exchange transaction could occur at the official exchange rate.
- 37. We note that a lack of exchangeability can arise in different forms. In the case of administrated exchangeability, there are several factors that could result in a currency not being exchangeable from a practical perspective. These factors include:
 - (a) limitations on the quantity of foreign currency that an entity might obtain.
 - (b) delays that an entity might face to obtain a desired quantity of foreign currency. The existence of excessive delays might create a practical lack of exchangeability.
 - (c) limitations on the purpose for which the desired quantity of foreign currency can be used. For example, jurisdictional authorities might grant access to foreign currency to import particular goods but not to pay dividends to foreign investors. Accordingly, the exchangeability of a currency might depend on the intended use of the foreign currency.

Lack of exchangeability over a longer term

38. Paragraph 26 of IAS 21 refers to a temporary lack of exchangeability—this is the only mention of a lack of exchangeability in IAS 21.
39. In our view, the requirements in paragraph 26 of IAS 21 on a temporary lack of exchangeability apply when:
 - (a) a currency is not exchangeable at the end of the reporting period, thus preventing the reporting entity from observing a closing rate; but
 - (b) the exchangeability of the currency is restored before the date on which the financial statements are authorised for issue.
40. In other words, we think those requirements capture circumstances in which the restoration of the currency's exchangeability is treated as an event occurring after the reporting period as defined by IAS 10 *Events after the Reporting Period*. In this case, the entity applies as the closing rate the rate prevailing on the day when the exchangeability of the currency is restored.
41. Our view is supported by the wording in paragraph 26 of IAS 21. The phrase '*first subsequent rate at which exchanges could be made*' implies that such a rate is available (and thus that exchangeability has been restored) when the financial statements of the entity are authorised for issue.
42. We also note similar requirements in US GAAP. Paragraph 30-45-9 of ASC 830 *Foreign Currency Matters* includes requirements similar to those included in paragraph 26 of IAS 21. Paragraph 30-55-1 of Topic 830 includes an example in which the exchangeability of a currency is lacking at the year-end but is restored in the early days of the subsequent reporting period.
43. Accordingly, we think a longer-term lack of exchangeability would arise only in the circumstances in which the currency is not exchangeable at the end of the reporting period and the exchangeability is not restored by the date on which the financial statements are authorised for issue.

The longer-term lack of exchangeability of VEF

44. In 2014, the Committee noted the existence of foreign exchange restrictions on the amount of VEF an entity could exchange for other currencies. The submitter assessed those restrictions as ‘severe’, but without any indication as to what those restrictions entailed.
45. Our research indicates the following regarding the exchangeability of VEF at present:
- (a) the legal supply of foreign currency in Venezuela is made only through administrated mechanisms regulated and directed by the jurisdictional authorities;
 - (b) many Venezuelan foreign operations are unable to obtain foreign currency to make investment-related payments (such as dividend payments to foreign investors), and have been unable to obtain foreign currency for this purpose for several years. The very few foreign operations succeeding in obtaining foreign currency for this purpose faced severe delays in the administrative process, and obtained a significantly lower amount of foreign currency than requested; and
 - (c) more generally, the exchangeability of VEF for any purpose is extremely limited, becoming increasingly so during 2017. We understand that, in recent months, Venezuelan foreign operations have been able to access foreign currency via the administered mechanism only in very small amounts and only for very limited purposes, such as for medical/humanitarian purposes.
46. It appears that VEF is subject to a longer-term lack of exchangeability, and one in which it is becoming increasingly difficult to observe any exchange transactions that might provide an exchange rate for immediate delivery of VEF for another currency.
47. In these circumstances, we think the official exchange rates of VEF do not meet the definition of a spot exchange rate in IAS 21 (ie the official exchange rates are not ‘the exchange rate for immediate delivery’). This is because Venezuelan foreign operations generally cannot exchange VEF for other currencies at the official exchange rates with immediate delivery. Accordingly, applying IAS 21 an entity

would not use the official exchange rates to translate the results and financial position of Venezuelan foreign operations.

48. Consequently, the case of Venezuela creates a set of circumstances in which the longer-term lack of exchangeability described above would appear to prevent an entity from observing the spot exchange rate—and hence the closing rate—to be used to translate the results and the financial position of the entity’s Venezuelan operations into its presentation currency. In these circumstances, we think in applying IAS 21 an entity would need to estimate the closing rate (ie the exchange rate for immediate delivery at the reporting date).

Estimating the closing rate

49. We acknowledge the challenges of estimating the closing rate. However, as indicated in our research, some entities have made such an estimation using an approach based on the Purchase Power Parity theory (see Appendices B and D to this paper).
50. We would expect an entity to include the effects of inflation in an estimated exchange rate because:
- (a) economic literature indicates that there is expected to be a relationship between exchange rates and inflation (see Appendix D to this paper); and
 - (b) some Standards already acknowledge this relationship. For example, paragraph 17 of IAS 29 states:

A general price index may not be available for the periods for which the restatement of property, plant and equipment is required by this Standard. In these circumstances, it may be necessary to use an estimate based, for example, on the movements in the exchange rate between the functional currency and a relatively stable foreign currency.

51. Having said that, we acknowledge that the case of Venezuela also creates challenges in identifying a reliable inflation rate (or changes in the general price index) that an entity would use to make such an estimation. Our research indicates that jurisdictional authorities have not recently provided any official data on inflation. Consequently, an entity might need to estimate the inflation rate, by for example

referring to information provided by third parties (such as academics or international organisations).

52. We also acknowledge that estimating the closing rate might result in different entities using different exchange rates when translating the results and financial position of Venezuelan foreign operations. Nonetheless, we note that IAS 1 *Presentation of Financial Statements* sets out a disclosure principle in relation to estimation uncertainty. Paragraph 125 of IAS 1 states:

An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

(a) their nature, and

(b) their carrying amount as at the end of the reporting period.

53. Paragraphs 126-133 of IAS 1 include requirements accompanying the disclosure principle set out above.
54. We note that the November 2014 Agenda Decision referred to particular disclosure requirements, including the requirements in IAS 1 mentioned above.

Other matters—consolidation

55. Our research identified that some entities deconsolidated Venezuelan operations some years ago (see Appendix B to this paper). We note the following with respect to IFRS 10 *Consolidated Financial Statements*:

- (a) Applying paragraph B80 of IFRS 10, an entity reassesses whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control (including power over the investee) listed in paragraph 7 of this Standard. In particular, when assessing whether the reporting entity has power over an investee, the reporting assesses whether its existing rights are substantive.

Paragraph B37⁹ of IFRS 10 mentions circumstances in which voting rights are not substantive.

- (b) We note however that IFRS 10 does not include any consolidation exception when the functional currency of an investee is subject to a longer-term lack of exchangeability. This is because the existence of such circumstances do not necessarily preclude control¹⁰. Accordingly, the matter described in this paper is not a circumstance that, in isolation, would result in the deconsolidation of Venezuelan subsidiaries.

Possible ways to address the matter

56. At this meeting, we will not ask the Committee to make any decisions. We think it would be helpful for the Committee to first discuss the matter before we then recommend a way forward, having considered the Committee's initial discussion. We would plan to bring a paper to the June 2018 Committee meeting that would include a recommendation for the Committee's consideration.
57. To facilitate discussion at this meeting, we have set out below the possible options that might be available to the Committee. We have also included our preliminary view on the best course of action.

⁹ Paragraph B37 states: 'An investor does not have power over an investee, even though the investor holds the majority of the voting rights in the investee, when those voting rights are not substantive. For example, an investor that has more than half of the voting rights in an investee cannot have power if the relevant activities are subject to direction by a government, court, administrator, receiver, liquidator or regulator'.

¹⁰ IAS 27 *Consolidate and Separate Financial Statements* (as revised in 2000) had required a subsidiary to be excluded from consolidation if it operated under severe long-term restrictions that significantly impaired the ability of the subsidiary to transfer funds to its parent. This consolidation exception was removed in 2008. Paragraph BCZ21 of the Basis for Conclusions on IFRS 10 states: 'The Board decided to remove the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that impair a subsidiary's ability to transfer funds to the parent. It did so because such circumstances may not preclude control. The Board decided that a parent, when assessing its ability to control a subsidiary, should consider restrictions on the transfer of funds from the subsidiary to the parent. In themselves, such restrictions do not preclude control.'

Option 1: confirm the November 2014 Agenda Decision ('status quo' approach)*Proposal*

58. The Committee could consider that the requirements in IAS 21, together with the November 2014 Agenda Decision (reproduced as Appendix A to this paper), are adequate to enable entities to determine their accounting and that no further action is required.

Staff assessment of the merits and drawbacks of this option

59. We identified the following merits of this approach:
- (a) entities with Venezuelan foreign operations have determined their accounting policies to apply to those operations. In saying that 'it is not entirely clear how IAS 21 applies in such situations', the November 2014 Agenda Decision may have provided some assurance to entities.
 - (b) the matter might be material and pervasive for those affected, but it currently affects foreign operations in only one jurisdiction (ie Venezuela).
60. We have also identified the following drawbacks:
- (a) the matter is a long-standing concern for some stakeholders, especially entities with Venezuelan foreign operations. The Agenda Decision published in 2014, in effect, left the matter unresolved. Stakeholders have signalled that recent developments in Venezuela have exacerbated the matter, and they are unsure of the appropriate accounting treatment applying IFRS Standards.
 - (b) the matter has given rise to diversity in reporting practices.
 - (c) some entities have started to estimate exchange rates. Without clarification as to when it is appropriate to use estimated rates, this practice might be applied inappropriately by analogy to other situations.

Option 2: recommend standard-setting

Proposal

61. The Committee could consider that the requirements in IAS 21, together with the November 2014 Agenda Decision, are adequate to enable entities to determine their accounting at present. However, in addition the Committee could:
 - (a) decide to add this matter to its standard-setting agenda, or
 - (b) recommend that the Board undertake narrow-scope amendments to IAS 21.

Staff assessment of the merits and drawbacks of this option

62. We identified the following merits of this approach:
 - (a) as indicated in our research, the matter has a material effect on those affected. It is also possible that narrow-scope standard-setting might resolve the issue efficiently. Accordingly, the matter might meet some or all of the criteria set out in paragraph 5.16 of the *Due Process Handbook* to be added the Committee's standard setting agenda.
 - (b) any standard-setting could specify requirements on the use of an estimated exchange rate and, thus, result in an improvement in financial reporting.
63. We have also identified the following drawbacks:
 - (a) this course of action would not help entities in applying IAS 21 in the short-term—the development of any narrow-scope amendment or Interpretation would require time. Stakeholders with whom we discussed the matter asked for more urgent action. It is also likely that any standard-setting would lead to the need to consider other circumstances (beyond those that exist in Venezuela) in which a currency is subject to a longer-term lack of exchangeability. In our view, the case of Venezuela is an extreme case of foreign exchange restrictions—because of this, we think it may be possible for the Committee to reach a conclusion regarding the application of the existing requirements in IAS 21 that could prove helpful to entities.
 - (b) the potential costs of undertaking a standard-setting project on this matter, even though narrow-in-scope, may outweigh the potential benefits. We

acknowledge that the matter might meet some of the criteria for standard-setting in paragraph 5.16 of the *Due Process Handbook*. However, we question whether the matter is so widespread that the potential benefits of changing the existing requirements would be of such significance that they would outweigh the potential costs. We also think that any standard-setting may not be straight-forward—as a minimum, such a project may need to consider requirements on how to estimate an exchange rate as well as describing the circumstances in which an estimated exchange rate could or should be applied. To date, the matter is material but only for some entities with operations in Venezuela.

- (c) as explained in paragraph 16 of this paper, the Board decided in 2016 not to add a project to its work plan on foreign currency translation. Any new standard-setting project would need to be considered a higher priority than other active or pipeline projects.

Option 3: publish a new Agenda Decision

Proposal

- 64. The Committee could decide to publish a new Agenda Decision with explanatory material on how an entity applies IAS 21 when there is a longer-term lack of exchangeability as experienced in Venezuela¹¹. The Agenda Decision could:
 - (a) describe the specific set of circumstances pertaining to Venezuela that result in a longer-term lack of exchangeability; and
 - (b) if the Committee were to agree with our analysis of the application of IAS 21, outline the Committee's conclusion on the use of an estimated exchange rate in those circumstances.

¹¹ Applying this option, the wording of the November 2014 Agenda Decision in relation to the exchange rate used when there are multiple exchange rates would be retained.

Staff assessment of the merits and drawbacks of this option

65. We think this approach would provide a timely response to a matter identified as urgent by stakeholders by explaining how to apply the existing requirements in IAS 21 to the circumstances in Venezuela.
66. However, although publishing an Agenda Decision would be expected to reduce diversity in reporting practices, it might not result in as significant an improvement in financial reporting as would be case if standard-setting were to be undertaken.

Staff preliminary view

67. Having considered stakeholders' concerns and assessed the possible options, we think the Committee should analyse the matter further and reconsider the conclusion reached in November 2014—ie Option 3 as described above. In particular, we think the Committee could publish an Agenda Decision with explanatory material that:
- (a) sheds additional light on the application of IAS 21 specifically in the circumstances faced in Venezuela; and thereby
 - (b) outlines an appropriate way of translating the results and financial position of a foreign operation in circumstances in which there is a longer-term lack of exchangeability of the severity faced in Venezuela.
68. Our analysis set out in paragraphs 31-55 of this paper could underpin any such Agenda Decision. We would suggest that any explanatory material in an Agenda Decision would:
- (a) describe the circumstances pertaining to Venezuela in setting out the scope of the Committee's discussion;
 - (b) discuss the use of an estimated exchange rate in those circumstances in the context of the definition of the closing rate in IAS 21; and
 - (c) refer to applicable disclosure requirements.
69. In addition, if considered helpful, the Agenda Decision could also discuss the requirements in IFRS 10 regarding the reassessment of control.

70. We think it would be beyond what is appropriate in an Agenda Decision to discuss how to estimate an exchange rate (as discussed in paragraphs 49-52 of this paper).

Questions 1 and 2 for the Committee

Question 1 – Do Committee members have any comments on the staff preliminary analysis set out in paragraphs 31-55 of this paper?

Question 2 – Do Committee members have any preliminary comments on the possible ways to address the matter discussed in paragraph 58-70 of this paper?

Appendix A – Extract from November 2014 *IFRIC Update*—agenda decision relating to IAS 21

IAS 21 *The Effects of Changes in Foreign Exchange Rates*—Foreign exchange restrictions and hyperinflation (Agenda Paper 10)

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

Concerns were raised that using an official exchange rate to translate an entity's net investment in a foreign operation in Venezuela appeared not to appropriately reflect the financial performance and position of the foreign operation in the group's consolidated financial statements.

The Interpretations Committee identified two primary accounting issues:

- (a) which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?
- (b) which rate should be used when there is a longer-term lack of exchangeability?

With respect to the first issue, the Interpretations Committee observed very little diversity in the application of IAS 21 regarding the principle to use when determining which rate, out of multiple rates, to use to translate an entity's net investment in a foreign operation. The Interpretations Committee noted that predominant practice is to apply the principle in paragraph 26 of IAS 21, which gives guidance on which exchange rate to use when reporting foreign currency transactions in the functional currency when several exchange rates are available. Hence, despite the issue's widespread applicability, the Interpretations Committee decided not to take the first issue onto its agenda.

With respect to the second issue, the Interpretations Committee observed that a longer-term lack of exchangeability is not addressed by the guidance in IAS 21, and so it is not entirely clear how IAS 21 applies in such situations. However, the Interpretations Committee thought that addressing this issue is a broader-scope project than it could address. Accordingly, the Interpretations Committee decided not to take this issue onto its agenda.

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

- (a) disclosure of significant accounting policies and significant judgements in applying those policies (paragraphs 117–124 of IAS 1);
- (b) disclosure of sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, which may include a sensitivity analysis (paragraphs 125–133 of IAS 1); and
- (c) disclosure about the nature and extent of significant restrictions on an entity's ability to access or use assets and to settle the liabilities of the group, or its joint ventures or associates (paragraphs 10, 13, 20 and 22 of IFRS 12).

Appendix B – Detailed summary of staff research

- B1. This appendix summarises research conducted and the related findings.
- B2. As explained in paragraph 17 of this paper, we reviewed the IFRS financial statements of twenty entities with foreign operations in Venezuela, and also conducted a more detailed survey of the reporting practices of some of those entities.

Review of a sample of financial statements

- B3. Our findings are presented in the table below:

Company	Industry	Jurisdiction	Revenue	Exchange rate used or accounting method used for Venezuelan operations at the end of FY 2016	Exchange rate* used as reference	Date at which the company departed from the official exchange rate
Use of official exchange rate(s)						
A	Oil & Gas	Europe	[30b€60b€]	Official exchange rate(s)	DICOM	N/A
B	Pharmaceutical	Europe	[30b€60b€]	Official exchange rate(s)	DICOM	N/A
C	Pharmaceutical	Europe	[30b€60b€]	Official exchange rate(s)	DICOM	N/A
D	Pharmaceutical	Europe	[20b€30b€]	Official exchange rate(s)	DIPRO	N/A
E	Service	Europe	[20b€30b€]	Official exchange rate(s)	DICOM	N/A
F	Beverage	America	[10b€20b€]	Official exchange rate(s)	SICAD, DIPRO, DICOM	N/A
G	General Industrials	Europe	[1b€10b€]	Official exchange rate(s)	DICOM	N/A
H	Construction	Europe	[1b€10b€]	Official exchange rate(s)	DICOM	N/A
I	Service	Europe	[0b€1b€]	Official exchange rate(s)	DICOM/SIMADI	N/A
J	Mining & metals	America	[0b€1b€]	Official exchange rate(s)	DICOM	N/A
Use of official exchange rate(s) until FY 2016 ; estimated exchange rate from FY 2017 onwards						
K	Telecommunication	Europe	[30b€60b€]	Official exchange rate(s)	DICOM	2017
L	Consumer goods	Europe	[1b€10b€]	Official exchange rate(s)	DICOM/SIMADI	2017
M	Hospitality	Europe	[1b€10b€]	Official exchange rate(s)	DICOM	2017
Estimated exchange rate and similar						
N	Bank	Europe	[20b€30b€]	Estimated exchange rate	N/A	2015
O	Insurance	Europe	[20b€30b€]	Estimated exchange rate	N/A	2015
P	Beverage	Europe	[10b€20b€]	Estimated exchange rate	N/A	2016
Q	Consumer Goods	Europe	[10b€20b€]	'Rate avoiding distortions'	N/A	N/A
R	Mining & metals	Europe	[1b€10b€]	'Economic rate'	N/A	2012
Deconsolidation of subsidiaries						
S	Consumer goods	Europe	[20b€30b€]	Deconsolidation of subsidiaries	N/A	2015
T	Consumer goods	America	[1b€10b€]	Deconsolidation of subsidiaries	N/A	2015

(*) For companies using an official exchange rate

- B4. At the end of the financial year 2016, we identified three main reporting practices:
- (a) financial statements of Venezuelan operations translated using one or more of the official exchange rates;
 - (b) financial statements of Venezuelan operations translated using an estimated exchange rate; and
 - (c) deconsolidation of Venezuelan subsidiaries.

Use of one or more of the official exchange rates

- B5. Thirteen entities used one or more of the official exchange rates in 2016. However, in 2017 three of those entities changed their reporting practice to use an estimated exchange rate when applying IAS 21. We observed that:

- (a) almost all entities disclosed the exchange rate(s) used.
- (b) most entities explained the circumstances faced in Venezuela, and the difficulties in identifying the exchange rate to use for the translation of the financial statements. A few entities reported this as a significant judgement or estimation applying IAS 1. A few entities also discussed their exposure to changes in the value of VEF in the context of the information required by IFRS 7 *Financial Instruments: Disclosures* on market risks.
- (c) the management commentary and/or financial statements of some entities with significant exposure to Venezuela included enhanced information. In some cases, that information isolated the effect of Venezuelan operations on the entity's consolidated results and financial position or key performance indicators.

Use of an estimated exchange rate

- B6. Five entities used an estimated exchange rate in translating its Venezuelan operations in 2016; this number increased to eight entities in 2017. In relation to this practice, we observed that:

- (a) most entities disclosed the estimated exchange rate used, together with a short description of how they determined the estimate. All entities reflected the inflation rate prevailing in Venezuela in the estimated exchange rate.
- (b) most entities explained the effect of using an estimated exchange rate. There were significant differences in the information and level of details provided. For example, one entity provided (i) simplified statements of financial position and profit or loss for its Venezuelan operations, and (ii) a comparison of the related balances showing amounts translated at one of the official rates and those translated at the estimated exchange rate. Conversely, some entities mentioned only the effect on some consolidated amounts (eg consolidated net income, shareholders equity, etc.).
- (c) some entities disclosed the use of an estimated exchange rate as a significant estimation.
- (d) on the basis of information available publicly, the estimated rates used as at 30 June 2017 ranged from USD 1:VEF 2,852 to USD 1:VEF 4,302. The fact that entities used a different currency benchmark (DICOM, SIMADI, SICAD¹²) as the starting point for their estimation is a major reason for the differences in exchange rate used.

Deconsolidation of Venezuelan subsidiaries

- B7. Two entities had deconsolidated subsidiaries in Venezuela some years ago—the related investments are accounted for at cost. It is not entirely clear whether the longer-term lack of exchangeability of VEF was one of the factors that triggered the deconsolidation of the subsidiaries. In the financial statements for the year during which the deconsolidation occurred:
- (a) one entity described the restrictions applied by the jurisdictional authorities on its operations in Venezuela and the difficulties arising therefrom in

¹² A monetary reform introduced the DIPRO and DICOM rates in 2016. The DIPRO rate was a fixed rate available for the settlement of some foreign exchange transactions (such as the import of food, medicines, etc.). The DICOM rate was an auction-based mechanism available for all other transactions. The SIMADI and SICAD rates were some of the rates that applied before the 2016 monetary reform.

exercising power over those operations. This entity also mentioned that the operations were no longer material.

- (b) the other entity described the foreign exchange restrictions, together with other regulations, as creating circumstances in which it did not effectively control the operations in Venezuela.

Summary

B8. Overall, we observed:

- (a) increasing use of an estimated exchange rate to translate the results and financial position of Venezuelan operations; and
- (b) significant differences in the disclosures provided. The fact that the matter has varying levels of significance for these entities (eg for some it is material and for others it is not) might explain those differences.

Detailed survey with some entities

Restrictions applying in Venezuela

B9. As noted above, we contacted several entities that assisted us by completing a detailed survey¹³. Those entities all confirmed that significant restrictions apply to the exchangeability of VEF. Many of those entities also reported that:

- (a) the supply of foreign currency is made through administrated mechanisms regulated and directed by jurisdictional authorities (the DICOM allocation is an auction-based mechanism);
- (b) the supply of foreign currency has decreased significantly over recent years;
- (c) they face undue delays in exchanging VEF. Several entities said VEF has not been exchangeable for any purpose since October 2017¹⁴; and

¹³ Those outreach activities took place in November and December 2017. The summary presented in this section therefore relies upon information that respondents shared with us at that time. We are not aware of subsequent developments that might significantly change the information included in this section.

¹⁴ We understand that the auctions officially resumed after the monetary reform that took place in 2018. However, we also understand that few exchange transactions have occurred.

- (d) additional restrictions have been placed on foreign currency to repatriate dividends or redeem intercompany loans. In general, entities have been not able to repatriate dividends since 2010.

Overall concern about the application of IAS 21

- B10. Almost all entities surveyed said the official exchange rates do not faithfully reflect inflation in Venezuela. In those entities' view, the exchange rate used for the translation of financial statements should reflect inflation. This explains why some entities used an estimated exchange rate when applying IAS 21.
- B11. Many entities said the application of IAS 29 and IAS 21, together with the use of one of the official exchange rates, results in the overstatement of:
 - (a) non-monetary assets and liabilities of Venezuelan operations; and
 - (b) the gain or loss recognised on the net monetary position of those operations.

For ease of understanding, Appendix C to this paper provides an illustrative example of the interaction between IAS 21 and IAS 29.

- B12. Many of those entities said the overstatement mentioned above distorts, and thus does not faithfully reflect, the contribution of Venezuelan operations to the group operations. One entity using one of the official exchange rates mentioned the volatility created by devaluations of VEF within its consolidated results.

Materiality of the matter

- B13. Venezuelan operations are material to group operations for some entities. Some entities using an estimated exchange rate said those operations would have been material if they had used one of the official exchange rates. Some entities also said:
 - (a) the gain or loss on the net monetary position of Venezuelan operations is material; and/or
 - (b) the use of an official exchange rate creates material distortions on the line items of the statement of profit or loss, including revenue and profit/loss for the period.

- B14. A few entities reported that the distortion arising from the use of one of the official exchange rates as described above has an effect on Earnings Per Share. One entity said the distortion might also affect debt covenants should it become more severe.

Use of an estimated exchange rate

- B15. Those using an estimated exchange rate said they used one of the official exchange rates as a starting point and adjusted it to reflect the real inflation rate in Venezuela. Some mentioned their starting point was a past exchange rate deemed to fairly reflect the inflation rate (one entity used the phrase ‘equilibrium rate’), which they then adjusted to reflect subsequent inflation.
- B16. Most entities also said they had to estimate the inflation rate in Venezuela because official data is not systematically available or reliable.

Appendix C – Discussion of the matter when the functional currency of a foreign operation is the currency of a hyperinflationary economy

- C1. We understand that Venezuela is considered to be a hyperinflationary economy as defined in IAS 29 *Financial Reporting in Hyperinflationary Economies*. In this situation, before applying IAS 21 an entity restates the financial statements of its Venezuelan foreign operations applying IAS 29.
- C2. Some stakeholders are of the view that, without the use of an estimated exchange rate, IAS 29 creates distortions in the information reported that do not arise if a foreign operation's functional currency is not the currency of a hyperinflationary economy.
- C3. In our view, the matter discussed in this paper and the application of IAS 29 are two separate matters that should not be conflated. We acknowledge that the application of IAS 29 may compound the severity of the matter discussed in this paper. However in our view the matter relates to the exchange rate used in applying IAS 21, and not to the requirements in IAS 29.
- C4. The following paragraphs present:
- (a) a summary of the requirements that apply when an entity consolidates a subsidiary¹⁵ for which the functional currency is the currency of a hyperinflationary economy; and
 - (b) a simplified illustrative example.

Requirements that apply in a hyperinflationary economy

- C5. The following requirements apply when the functional currency of a subsidiary is the currency of a hyperinflationary economy:
- (a) applying paragraph 43 of IAS 21, the financial statements of the subsidiary are first restated applying IAS 29. Specifically:

¹⁵ For ease of reference, this appendix considers only the case of a foreign operation that is a subsidiary. Our conclusion would also apply in situations in which an entity accounts for a foreign operation using the equity method (paragraph 20 of IAS 29).

- (i) the subsidiary's statement of financial position is restated in terms of the measuring unit current at the end of the reporting period:
 - monetary items are not restated because they are already expressed in terms of the monetary unit current at the end of the reporting period; and
 - non-monetary items carried at historical cost are restated. For example, the entity determines the restated cost of a monetary asset by applying to its historical cost the change in a general price index from the date of its acquisition to the end of the reporting period.
 - (ii) a gain or loss on the net monetary position of the subsidiary is recognised in profit or loss; and
 - (iii) all amounts recognised in the statement of comprehensive income are restated by applying the change in the general price index from the dates when the items of income and expenses were initially recorded in the financial statements.
- (b) applying paragraph 42(a) of IAS 21, the entity then translates the subsidiary's restated financial statements from the functional currency to its presentation currency at the closing rate at the date of the most recent statement of financial position.
- (c) applying paragraph 42(b) of IAS 21, the entity does *not* restate comparative amounts ie the comparative amounts are those presented in prior year financial statements. The entity does not adjust comparative amounts for subsequent changes in the price level or subsequent changes in exchange rates.

Simplified illustrative example

C6. For ease of reference, we considered a simplified illustrative example as follows:

- (a) A reporting entity (Entity A) has a presentation currency of the Euro (€). In this example, the inflation rate of the Eurozone is assumed to be zero.

- (b) Entity A's reporting date is 31 December.
- C7. Entity A owns all the shares of, and controls, Entity B. Entity B:
- (a) has a functional currency of Local Currency (LC)—the rate at which this currency can be exchanged against other currencies is set by jurisdictional authorities;
 - (b) was set up on 31 December 20X6 through the investment of LC 1,000 by Entity A;
 - (c) used the proceeds of this investment to buy a non-depreciable, non-monetary asset for LC 1,000; and
 - (d) did not generate any revenue or incur any expenses in 20X7.
- C8. The economy within which Entity B operates is hyperinflationary in 20X6 and 20X7. The Consumer Price Index of this hyperinflationary economy is as follows:
- (a) 1 January 20X7: 100,
 - (b) 31 December 20X7: 210 (ie the inflation rate over 20X7 is 110%).
- C9. At 31 December 20X6, the exchange rate between the two currencies considered in this example is as follows: LC 1 : € 0.800.
- C10. At 31 December 20X6, in preparing its consolidated financial statements Entity A restates and translates Entity B's financial statements as follows:
- (a) applying IAS 29, Entity A restates the amount of the asset owned by Entity B to reflect inflation at the end of the reporting period. Because the asset was purchased on 31 December 20X6, its restated amount is equal to its historical cost. No restatement is made and the asset's carrying amount is LC 1,000.
 - (b) applying IAS 21, Entity A translates Entity B's financial statements at the closing rate of LC 1 = € 0.800. In Entity A's consolidated financial statements, the carrying amount of the asset owned by Entity B is $\text{LC } 1,000 \times 0.8 = \text{€ } 800$.

- C11. Applying paragraph 42(b) of IAS 21, the carrying amount of the asset at 31 December 20X6 presented as comparative information in Entity's A consolidated financial statements as at 31 December 20X7 will be unchanged at € 800.
- C12. We have considered below various scenarios with respect to the exchange rate used at 31 December 20X7.

Scenario 1: LC is devalued in a manner commensurate with inflation prevailing in Entity B's jurisdiction

- C13. In this scenario, we assume the closing exchange rate as at 31 December 20X7 is LC 1 : € 0.381 (devaluation of LC against the Euro).
- C14. At 31 December 20X7:
- (a) Entity A restates the carrying amount of the asset owned by Entity B to reflect inflation at that date. The restated carrying amount of the asset is LC 2,100 ($1,000 \times (210 \div 100) = \text{LC } 2,100$).
 - (b) Entity A then translates this amount—denominated in LC—at the closing exchange rate. The translated carrying amount of the asset is **€ 800** ($\text{LC } 2,100 \times 0.381 \cong \text{€ } 800$).
- C15. In this scenario, the carrying amount of the asset reported in Entity A's consolidated financial statements is unchanged at € 800 at the end of 20X6 and 20X7. This is because the increase in inflation in Entity B's jurisdiction—which is reflected in the asset's carrying amount through the restatement required by IAS 29—is exactly offset by a decrease in the exchange rate of LC. In that scenario, the application of IAS 29 and IAS 21 does not create any distortion in the carrying amount of the asset.

Scenario 2: LC is not devalued – the exchange rate is kept unchanged by jurisdictional authorities

- C16. In this scenario, we assume the closing exchange rate as at 31 December 20X7 is LC 1 : € 0.800 (ie no change in the exchange rate of the LC against the Euro).

C17. At 31 December 20X7:

- (a) Entity A restates the amount of the asset owned by Entity B to reflect inflation at that date. The restated carrying amount of the asset is LC 2,100 (see computation in paragraph C14(a)).
- (b) Entity A translates this amount—denominated in LC—at the closing exchange rate. The translated carrying amount is € 1,680 ($LC\ 2,100 \times 0.800 = €\ 1,680$).

C18. In this scenario, the carrying amount of the asset reported in Entity's A consolidated financial statements increases from € 800 at the end of 20X6 to € 1,680 at the end of 20X7. This is because the restated carrying amount of the asset reflects inflation in Entity B's jurisdiction (applying IAS 29) but that restated amount—denominated in LC—is subsequently translated into Entity A's presentation currency using an exchange rate that is not adjusted for inflation. Consequently, the carrying amount of the asset—presented in Euro—increases. The restatement described in this paragraph results in a corresponding adjustment to equity.

Scenario 3: LC is devalued but not in a manner commensurate with inflation prevailing in Entity B's jurisdiction

C19. In this scenario, we assume the closing exchange rate as at 31 December 20X7 is LC 1 : € 0.500.

C20. At 31 December, 20X7:

- (a) Entity A restates the amount of the asset owned by Entity B to reflect inflation at that date. The restated carrying amount of the asset is LC 2,100 (see computation in paragraph C14(a)).
- (b) Entity A translates this amount—denominated in LC—at the closing exchange rate. The translated carrying amount is € 1,050 ($LC\ 2,100 \times 0.500 = €\ 1,050$).

C21. In this scenario, the carrying amount of the asset reported in Entity A's consolidated financial statements increases from € 800 at the end of 20X6 to € 1,050 at the end of 20X7. The rationale for such an increase is the same as that outlined in paragraph C18.

Conclusion

- C22. Scenarios 2 and 3 illustrate that the carrying amounts of non-monetary assets and liabilities located in hyperinflationary economies are distorted when an entity translates those balances using an exchange rate that does not vary in line with inflation prevailing in those economies.
- C23. This appendix illustrates the effects on the statement of financial position. In practice, there are also likely to be effects on profit or loss. For example, if Entity B had monetary assets of LC 1,200 and monetary liabilities of LC 200 at the end of both 20X6 and 20X7 (ie Entity B has a positive net monetary position of LC 1,000), it would have computed a loss on its net monetary position of LC1,100¹⁶ for 20X7. Entity B would recognise this loss—computed in LC—in profit and loss, which would also be reported in Entity A’s consolidated profit or loss. Similarly, if Entity B had monetary assets of LC 200 and monetary liabilities of LC 1,200 at the end of both 20X6 and 20X7 (ie Entity B has a negative net monetary position of LC 1,000), it would have computed a gain on its net monetary position of LC 1,100. Entity B would recognise this gain—computed in LC—in profit and loss, and this would again be reported in Entity A’s consolidated profit or loss.

¹⁶ The computation of a gain or loss on a net monetary position is required by paragraphs 27-28 of IAS 29.

Appendix D – Inflation and exchange rates (educational material)

D1. This appendix is designed to provide the Committee with an overview of the economic theory highlighting inflation as one of the main determinant of exchange rates. This appendix is not a comprehensive study discussing all the determinants of exchange rate (interest rates, growth, etc.). It aims only to provide an overview of the theories setting out a link between inflation and the changes in exchange rates, thereby supporting the analysis that an estimated exchange rate would generally be expected to reflect inflation.

D2. The Law of One Price (an economic theory) says in the absence of transportation costs, tariffs and restrictions on the movement of goods, identical goods should sell for the same price—expressed in terms of a common currency—on two separate markets. If goods were to trade at different prices, there would be opportunities for arbitrage and prices would eventually become equal. In other words, this law says the price of a good is the same wherever it is sold.

For example, if $P'_{\text{€}}$ is the selling price of a good in the Eurozone, $P'_{\text{\$}}$ is the selling price in the US and $FX_{\text{\$/€}}$ is the US dollar/Euro exchange rate, the relationship is as follows:

$$P'_{\text{€}} = P'_{\text{\$}} \times FX_{\text{\$/€}} \Leftrightarrow FX_{\text{\$/€}} = P'_{\text{€}} \div P'_{\text{\$}}$$

D3. The Purchase Power Parity (PPP) theory is derived by applying the Law of One Price to multiple commodities in an international environment. In other words, the PPP theory is the Law of One Price applied to the entire consumption basket of a jurisdiction (or monetary area). If $P_{\text{€}}$ is the price index in the Eurozone, $P_{\text{\$}}$ is the price index in the US and $FX_{\text{€/\$}}$ is the US dollar/Euro exchange rate, the equation shown in paragraph D2 can be restated as follows:

$$P_{\text{€}} = P_{\text{\$}} \times FX_{\text{\$/€}} \Leftrightarrow FX_{\text{\$/€}} = P_{\text{€}} \div P_{\text{\$}}$$

Said differently, $FX_{\text{\$/€}}$ is the spot exchange at which prices in the Eurozone are equal to prices in the US.

D4. The relationship outlined in paragraph D3 is referred to as the ‘absolute PPP’. The ‘relative PPP’ model is derived from the ‘absolute PPP’ relationship. The relative PPP model predicts that, over time, the exchange rate between two currencies will

adjust to offset inflation differences between the two underlying jurisdictions (or monetary areas). In other words, according to the relative PPP model the change in the exchange rate between two currencies over any period is entirely driven by differences in the changes in price levels in the two underlying jurisdictions (or monetary areas). If inflation rates are very small, the equation shown in paragraph D3 could be approximated as follows¹⁷:

$$\Delta FX_{\$/\epsilon} = \Delta P_{\epsilon} \div \Delta P_{\$} \Leftrightarrow \Delta FX_{\$/\epsilon} \cong i_{\epsilon} - i_{\$}$$

...where i_{ϵ} is in the inflation rate in the Eurozone over a period and $i_{\$}$ is the inflation rate in the US over that same period. In this case, the change in the exchange rate is approximately equal to the difference between the inflation rates in the US and the Eurozone.

- D5. Assuming the exchange rate between two currencies is entirely determined by inflation, the relative PPP model could be used to compute a forward exchange rate taking into account the anticipated inflation rates of the jurisdictions (or monetary areas). For example, assuming that inflation rates are not small, the forward exchange rate in 12 months' time ($FX'_{\$/\epsilon}$) could be derived as follows¹⁸:

$$FX'_{\$/\epsilon} = FX_{\$/\epsilon} \times (1 + i_{\epsilon}) \div (1 + i_{\$})$$

... where $FX_{\$/\epsilon}$ is the spot exchange rate.

- D6. We understand that the formula in paragraph D5 above can be used to estimate at a specific reporting date — ie 'ex post'. For instance, the 'theoretical' spot exchange rate as at 31 December 20X7 is computed by using as a starting point the spot exchange rate as at 31 December 20X6, then adjusted by the inflation rates observed during the year 20X7.
- D7. The 'relative PPP' model provides a framework to explain the changes in exchange rates over the long-term. However, over the short-term, its predictive capabilities is much debated among economists.

¹⁷ We use the symbol Δ with the meaning 'change in'.

¹⁸ This formula can be used to compute the 'equilibrium' exchange rate used in paragraph C13 of the simplified example shown in Appendix C to this paper. In that example, we had: $0.8 \times (1+0\%) \div (1+10\%) \cong \text{€ } 0.381$.