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STAFF PAPER

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Project	**Lack of Exchangeability (IAS 21)**
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Introduction and purpose

1. As explained in Agenda Paper 12B for this meeting, this paper presents our analysis and recommendations on the spot exchange rate (spot rate) an entity uses when a currency lacks exchangeability.

Structure of the paper

2. This paper includes:
   (a) a summary of our recommendations (paragraphs 4–5); and
   (b) our analysis and recommendations (paragraphs 6–41).

3. This paper also includes two appendices:
   (a) Appendix A—Flowchart summarising our recommendations; and
   (b) Appendix B—Other considerations.

Summary of our recommendations

4. We recommend that:
   (a) an entity estimate the spot rate when a currency lacks exchangeability.
   (b) any proposed amendment set out an objective for the estimation process. The objective would require an entity to estimate a spot rate that:

(i) the entity would have been able to access at the reporting date had exchangeability (as defined in Agenda Paper 12C) not been lacking;

(ii) would have arisen in an orderly transaction between market participants; and

(iii) would faithfully reflect the economic conditions prevailing at that date.

(c) an entity be permitted to use an observable rate (that does not meet the definition of a spot rate) if that rate approximates the spot rate in the following circumstances:

(i) when the observable rate meets the definition of a spot rate for particular transactions or balances but not those for which the entity assesses exchangeability; or

(ii) when the observable rate is the first subsequent rate at which exchanges could be made if exchangeability is restored before financial statements are authorised for issue.

(d) an entity apply an estimated exchange rate to:

(i) the entire transaction or balance of an asset or liability (when the entity reports foreign currency transactions in the functional currency); or

(ii) the financial statements as a whole (when the entity uses a presentation currency other than the functional currency).

5. The flowchart in Appendix A to this paper summarises our recommendations.

Staff analysis and recommendations

Proposed approach

6. Our proposed approach builds on the requirement in IAS 21 to use a spot rate. Paragraph 8 of IAS 21 defines a spot rate as ‘the exchange rate for immediate delivery’. Applying our proposed definition of exchangeability (as set out in Agenda Paper 12C), exchangeability is lacking when an entity would be unable to exchange a currency for another currency at a specified date. Accordingly, a lack of

exchangeability results in an entity being unable to observe a spot rate at the reporting date.

7. In our view, when a currency is not exchangeable, an entity should estimate a spot rate. The objective should be to estimate a spot rate that:

   (a) the entity would have been able to access at the reporting date had exchangeability (as defined in Agenda Paper 12C) not been lacking;

   (b) would have arisen in an orderly transaction between market participants[1]; and

   (c) would faithfully reflect the economic conditions prevailing at that date.

8. We conclude that this approach, together with relevant disclosure (see Agenda Paper 12E), would faithfully represent the amounts at which assets and liabilities could have been realised (settled) at the reporting date had the currency been exchangeable.

9. Nonetheless, a lack of exchangeability would not automatically mean that an entity would be required to use an estimation technique to determine the spot rate. There are circumstances in which an entity might use an observable rate (that is not a spot rate) as a proxy for the estimated spot rate. This would be the case when an observable rate meets the objective specified in paragraph 7 of this paper. This could occur when:

   (a) a rate is observable at the reporting date but applies only to transactions or balances other than the transaction or balance for which the entity assesses exchangeability (see paragraphs 22–26 below); or

   (b) exchangeability is restored after the end of the reporting period but before financial statements are authorised for issue. In this situation, a rate is observable at a date after the reporting date (see paragraphs 27–30 below).

Staff recommendations

10. We recommend that an entity estimate the spot rate when exchangeability of a currency is lacking. An entity would use that estimated spot rate when:

   (a) it reports foreign currency transactions in the functional currency; and

[1] Appendix A to IFRS 13 *Fair Value Measurement* defines ‘market participants’ and ‘orderly transactions’.

(b) uses a presentation currency other than the functional currency.

11. In such circumstances, we further recommend setting out an objective for the estimation process. The objective would require an entity to estimate a rate that:

(a) the entity would have been able to access at the reporting date had exchangeability (as defined in Agenda Paper 12C) not been lacking;

(b) would have arisen in an orderly transaction between market participants; and

(c) would faithfully reflect the economic conditions prevailing at that date.

Applying the proposed approach

Estimating the spot rate

12. There are many economic models (with varying degrees of complexity) that an entity might use to estimate a spot rate. Those models (or techniques) use one or several of the following economic factors as inputs:

(a) inflation (or the level of prices).

(b) interest rates.

(c) the balance of payments—the jurisdictional money supply and demand.

(d) a jurisdiction's productivity.

(e) other factors.

13. For example, one economic theory, the Purchasing Power Parity Theory, highlights inflation as one of the key determinants of exchange rates[2].

14. Estimating a spot rate could be a complex process that may require the use of judgement. Accordingly, we recommend that any amendment narrow the circumstances in which an entity would use an estimated spot rate. This would mitigate concerns about estimation complexities.

[2] Appendix C to Agenda Paper 12D for the November 2019 Board meeting provides further information about this theory

15. We considered two ways of narrowing those circumstances:

    (a) defining narrowly a lack of exchangeability. Our recommendations in Agenda Paper 12C meet this objective.

    (b) permitting the use of an observable rate (that does not meet the definition of a spot rate) if that rate would approximate the spot rate that would have been observed at the reporting date had the currency been exchangeable. Paragraphs 21–32 of this paper discuss this further.

16. We note that, in estimating the spot rate, an entity would not necessarily need to use a complex estimation technique (that would involve consideration of all possible economic factors). In some situations, an entity could estimate the spot rate by starting with either (a) an observable rate that does not meet the definition of a spot rate[3], or (ii) a spot rate at a date other than the reporting date. The entity would then adjust that observable rate, as necessary, to estimate the spot rate at the reporting date.

Prescriptive requirements regarding estimation

17. We recommend that any amendment neither specify detailed requirements on how to estimate a spot rate, nor prescribe a particular technique for it. The recommendation regarding defining exchangeability (in Agenda Paper 12C) is to be prescriptive in setting the parameters for when an entity would estimate the spot rate, and to set those parameters so that they would be met only in a narrow set of circumstances. Because of that, it would be unnecessary to be more prescriptive regarding how to estimate the spot rate.

18. We considered the risks of not prescribing detailed requirements regarding estimation—ie that entities use different estimation techniques, possibly leading to a lack of comparability between entities. However, we recommend a principle-based approach to estimation on the grounds that:

    (a) the matter of estimating an exchange rate is debated among economists. We understand there is no consensus on which technique might provide the best outcome;

[3] For example, an official exchange rate that the entity cannot access, or a rate observed on a market that the entity has not considered when assessing exchangeability (see paragraphs 20–25 in Agenda Paper 12C)

(b) the selection of an appropriate estimation technique may require the use of judgement, considering entity and jurisdiction-specific facts and circumstances;

(c) estimation models have varying degrees of complexity;

(d) identifying an appropriate estimation technique could result in (i) extensive standard-setting work, and (ii) not capturing all relevant factors for all possible situations; and

(e) this approach is consistent with the overall approach in IFRS Standards, and with the measurement requirements in particular Standards. For example, IFRS 9 *Financial Instruments* does not specify any particular technique for the measurement of expected credit losses, but instead sets out a clear objective.

19. We also considered whether the possible complexity involved in estimating a spot rate, together with no prescribed estimation technique, could result in significant uncertainties about the rate estimated and, thus, could undermine the principle of faithful representation. We conclude that the uncertainties inherent in estimating a spot rate are not different from those that relate to other financial information based on estimates. The use of estimates is embedded in preparing IFRS financial statements. Paragraph 2.18 of the 2018 *Conceptual Framework for Financial Reporting* states:

> Faithful representation does not mean accurate in all respects... For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

20. We recommend that an entity disclose information when it estimates a spot rate—Agenda Paper 12E includes our recommendations in this respect. Such disclosures would help alleviate concerns regarding faithful representation.

Using an observable rate as an approximation for the spot rate

21. In some situations, an entity might be able to use an unadjusted observable rate that would:

    (a) not meet the definition a spot rate for a specified transaction; but

    (b) meet the objective of estimating a spot rate (see paragraph 7 of this paper).

Using an observable rate at the reporting date

22. In Agenda Paper 12C, we recommend that the definition of exchangeability includes consideration of the purpose for which an entity obtains foreign currency. Accordingly, a currency may not be exchangeable for a particular purpose but may be exchangeable for other purposes.

23. In some situations, an entity might conclude that the observable rate for some transactions or balances approximates the spot rate for the transaction or balance for which exchangeability is lacking. Therefore, an entity could use the observable rate for those other transactions at the reporting date, without needing to use an estimation technique.

> For example, assume an entity has a foreign operation in a jurisdiction whose currency is free-floating with limited intervention by the jurisdictional authorities. There is one exchange rate that applies to all exchange transactions and this rate faithfully reflects economic conditions prevailing at the reporting date. However, jurisdictional authorities do not allow entities to obtain foreign currency for a purpose that would result in the entity recovering its net investment in the foreign operation (for example, dividend-remittances).
>
> In this example, the facts and circumstances indicate that the observable rate applying to transactions for which the currency is exchangeable could approximate the spot rate for other transactions, such as paying dividends. This is because the facts and circumstances indicate that this rate would have applied at the reporting date (ie there is only one exchange rate for the currency and that rate faithfully reflects economic conditions prevailing at the reporting date).

24. In our view, an entity could consider the following non-exhaustive list of indicators when assessing whether an observable rate approximates the spot rate:

    (a) *the nature of the exchange rate structure*—ie whether several exchange rates exist for the currency. The existence of more than one exchange rate indicates that the monetary or jurisdictional authorities set exchange rates to encourage, or deter, entities from entering into particular transactions. Accordingly, the differing observable rates may include a 'penalty' or 'incentive', and may not faithfully reflect all relevant economic conditions.

(b) *the number and type of transactions for which the currency is exchangeable*—if an entity could obtain foreign currency for only particular types of transactions (such as emergency supplies), the exchange rate observed may not faithfully reflect all relevant economic conditions.

(c) *the nature of the exchange rate arrangement*—a free-floating exchange rate observable on a market would more faithfully reflect economic conditions than an exchange rate set through regular interventions from the monetary or jurisdictional authorities.

(d) *the frequency at which exchange rates are updated*—an exchange rate that is unchanged over a long period of time is less likely to faithfully reflect economic conditions than a rate that is updated every day, or several times per day.

25. We see benefit in:

(a) explicitly permitting an entity to use an observable rate if that rate would approximate the spot rate; and

(b) listing the indicators in paragraph 24 above as application guidance to help entities assess whether the observable rate approximates the spot rate at the reporting date.

26. Doing so would also address possible concerns about the proposed definitions of exchangeability and a lack thereof (see Agenda Paper 12C). Some entities might experience long delays when realising their net investment in some foreign operations (such as through the remittance of dividends). In such circumstances, entities may conclude that the functional currency of a foreign operation is not exchangeable for transactions that would result in realising the entity's net investment in the foreign operation. However, in many of those jurisdictions the local currency may be exchangeable for other purposes. Applying the proposed approach in paragraph 25, an entity might often be able to use an observable rate as an approximation for the spot rate at the reporting date.

Using the first subsequent rate at which exchanges could be made

27. Paragraph 26 of IAS 21 requires an entity that reports foreign currency transactions in a functional currency to use the first subsequent rate at which exchanges could be made if exchangeability is temporarily lacking. Requiring the use of an estimated exchange rate for all circumstances in which exchangeability is lacking would result in amending those requirements in paragraph 26 of IAS 21.

28. That said, there are circumstances in which an entity might conclude that the first subsequent rate at which transactions could be made approximates the spot rate for the transaction or balance for which exchangeability is lacking. Accordingly, an entity could use this rate as the spot rate at the reporting date.

29. In our view, an entity could consider the following non-exhaustive list of indicators when assessing whether the first subsequent observable rate approximates the spot rate:

    (a) *the time period between the reporting date and the date at which exchangeability is restored*—the likelihood that the first subsequent rate would approximate the spot rate at the reporting date would reduce as the time period that elapses increases. This is because economic conditions could change significantly over a long period.

    (b) *whether the currency is the one of a hyperinflationary or highly-inflationary economy*—inflation is a key determinant of the exchange rate. In general, the exchange rate decreases in a manner commensurate with inflation. When a currency is hyperinflationary (or highly-inflationary), prices change quickly and might even change several times per day. Accordingly, the first subsequent rate for a hyperinflationary currency is unlikely to approximate the spot rate at the reporting date.

30. Again, we see benefit in:

    (a) explicitly permitting an entity to use the first subsequent rate for the purpose of a specified transaction if that rate would approximate the spot rate; and

(b) listing the indicators in paragraph 29 above as application guidance to help entities assess whether that rate would approximate the spot rate at the reporting date.

Staff recommendations

31. We recommend neither specifying how an entity estimates the spot rate at the reporting date nor prescribing a particular estimation technique.

32. We also recommend an entity be permitted to use an observable rate (that does not meet the definition of a spot rate) if that rate approximates the spot rate in the following circumstances:

(a) when the observable rate meets the definition of a spot rate for particular transactions or balances but not those for which the entity assesses exchangeability; or

(b) when the observable rate is the first subsequent rate at which exchanges could be made if exchangeability is restored before financial statements are authorised for issue.

Ability to convert only some amounts of foreign currency

Analysis

33. As discussed in Agenda Paper 12C, we recommend specifying that exchangeability is lacking when an entity would be able to exchange no more than an insignificant amount of foreign currency. Because there could be an observable spot rate for some portion of a foreign currency transaction, we considered whether an entity should be required to use:

(a) a blended rate ('blended approach') that would reflect both:

(i) the rate the entity could obtain for the exchangeable portion of the transaction, and

(ii) an estimated rate for the remaining portion; or

(b) an estimated rate for the entire transaction ('estimated approach').

34. The use of the blended approach would, in our view, faithfully depict a foreign currency transaction or balance. Nonetheless, we recommend the estimated approach on the grounds that:

(a) applying the blended approach could be practically challenging, thereby increasing costs for preparers without providing significant additional benefits.

(b) an entity would be able to exchange only an insignificant amount of foreign currency[4]. Accordingly, applying the blended approach an entity would use the observable spot rate only for an insignificant portion of the transaction or balance (and the estimated rate for the remaining portion). In most cases, we would expect the outcome not to differ significantly from the estimated approach.

35. We considered whether to give entities the option of applying either the estimated approach or the blended approach but decided not to do so. The situation contemplated would be expected to arise infrequently (ie only when an entity is able to exchange some, but less than an insignificant, amount of foreign currency) and allowing an option would increase the complexity of the requirements (and reduce comparability). We think that there might be situations in which the observable rate (that applies to the exchangeable portion of the transaction) approximates the spot rate for the entire transaction. Accordingly, an entity might be able to use the observable rate with no adjustments, which would result in no difference between the two approaches.

Staff recommendation

36. When exchangeability is lacking, we recommend that an entity apply an estimated exchange rate to (a) the entire transaction or balance of an asset or liability (when the entity reports foreign currency transactions in the functional currency), or (b) the financial statements as a whole (when an entity uses a presentation currency other than the functional currency).

[4] This is based on our recommendation that exchangeability is lacking when an entity is able to obtain no more than an insignificant amount of foreign currency.

Other matters

37. At the November 2019 meeting, some Board members suggested alternative approaches for the determination of the spot rate. Appendix B to this paper summarises and analyses those approaches.

38. Appendix B also analyses two other matters relating to estimating the spot rate. In particular, it discusses situations in which:

    (a) the functional currency is that of a hyperinflationary economy; and

    (b) a currency is only indirectly exchangeable into another currency.

39. Based on our analysis in Appendix B, we recommend no specific requirements in respect of those other matters.

Staff recommendations

40. We recommend that:

    (a) an entity estimate the spot rate when a currency lacks exchangeability. An entity would use that estimated rate both when:

        (i) it reports foreign currency transactions in its functional currency; and

        (ii) uses a presentation currency other than the functional currency.

    (b) any proposed amendment set out an objective for the related estimation process and not specify how an entity estimates the spot rate at the reporting date nor prescribe a particular estimation technique. The objective would require an entity to estimate a rate that:

        (i) the entity would have been able to access at the reporting date had exchangeability (as defined in Agenda Paper 12C) not been lacking;

        (ii) would have arisen in an orderly transaction between market participants; and

        (iii) would faithfully reflect the economic conditions prevailing at that date.

(c) an entity be permitted to use an observable rate (that does not meet the definition of a spot rate) if that rate approximates the spot rate in the following circumstances:

  (i) when the observable rate meets the definition of a spot rate for particular transactions or balances but not those for which the entity assesses exchangeability; or

  (ii) when the observable rate is the first subsequent rate at which exchanges could be made if exchangeability is restored before financial statements are authorised for issue.

(d) an entity apply an estimated exchange rate to:

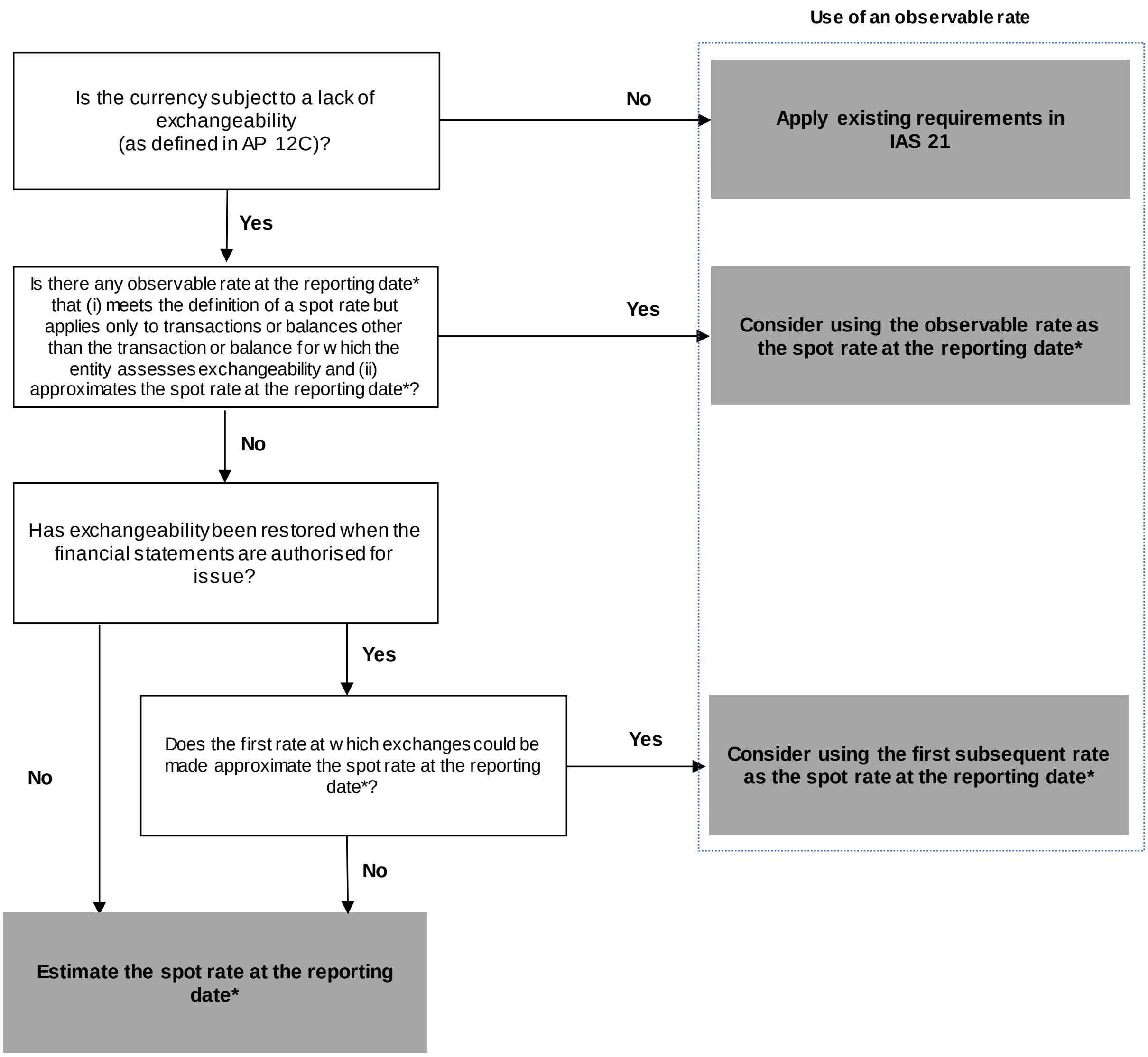
  (i) the entire transaction or balance of an asset or liability (when the entity reports foreign currency transactions in the functional currency), or

  (ii) the financial statements as a whole (when an entity uses a presentation currency other than the functional currency).

41. The flowchart in Appendix A summarises our recommendations.

Question for the Board
Does the Board agree with our analysis and recommendations on the spot rate that an entity uses when a currency lacks exchangeability?

Appendix A—Flowchart summarising the staff recommendations



or at the date of the transactions

Appendix B—Other considerations

B1. This appendix analyses:

(a) the alternative approaches suggested at the Board's November 2019 meeting; and

(b) two other matters relating to how an entity estimates a spot rate.

Alternative approaches

B2. Applying our proposed definition of exchangeability (and a lack thereof) in Agenda Paper 12C, a currency would lack exchangeability if the entity is able to obtain no more an than an insignificant amount of foreign currency for a particular purpose. Applying our recommendations in this paper, the entity would estimate the spot rate for that currency in line with the proposed estimation objectives in paragraph 7.

Summary of the alternative approaches

B3. At the Board's November 2019 meeting, two Board members suggested defining a currency's exchangeability such that a currency would lack exchangeability when, for a specified purpose, an entity is able to obtain less than the entire amount of foreign currency (ie Alternative IV described in paragraph 54 of Agenda Paper 12C). In particular:

(a) one Board member said it would be appropriate to estimate a spot rate in any situation in which an entity is able to obtain less than the entire amount of foreign currency—this is because an estimated spot rate might more faithfully represent the economic conditions than an observable spot rate.

(b) the other Board member suggested additional requirements with respect to how an entity determines the spot rate in those circumstances. While agreeing with the proposed estimation objectives in paragraph 7, this Board member suggested requiring an entity to use an observable rate that does not meet the definition of a spot rate—either at the reporting date (see paragraphs 22–26) or the first subsequent exchange rate (see paragraphs 27–30)—if that rate meets the estimation objectives in paragraph 7. Accordingly, an entity would estimate the spot rate only if it were unable to identify an observable rate that meets those estimation objectives. This approach would be similar to the approach in IFRS 13 which sets out a hierarchy of inputs an entity uses when measuring the fair value of an asset or liability[5].

B4. Both Board members acknowledged that their suggested definition for a currency's lack of exchangeability could result in identifying more currencies lacking exchangeability than our recommended approach. However, the Board member supporting the approach described in paragraph B3(b) said putting more constraints on when an entity estimates a spot rate would result in a similar outcome as that of our recommended approach.

Staff analysis and recommendation

B5. We agree that the alternative approaches described in paragraph B3 would simplify the assessment of when a currency lacks exchangeability by removing the need to apply judgment in situations in which an entity can obtain only some amounts of foreign currency. We also see benefit in requiring an entity to use an observable rate that meets the estimation objectives in paragraph 7.

B6. However, we recommend the Board not proceed with these approaches because they could result in identifying more currencies that lack exchangeability than our recommended approach. This, in turn, could:

(a) go beyond the intended scope of this project without providing more useful information to users. Several Board members said this project should be narrow in scope. We also consulted some investors in connection with our research into the disclosures that an entity should provide when a currency lacks exchangeability (see Agenda Paper 12E). These users recommend defining a lack of exchangeability to capture only situations in which a currency genuinely lacks exchangeability, such as the situation currently existing in Venezuela—they do not see benefits in identifying a lack of exchangeability in other circumstances.

[5] Paragraphs 72–90 of IFRS 13 set out requirements for the 'fair value hierarchy'.

(b) increase the circumstances in which an entity might use an estimated spot rate[6]. We think the general principle in IAS 21 is to use an observable spot rate, regardless of whether that rate faithfully represents the economic conditions—accordingly, we think any standard-setting should limit the circumstances in which an entity may use estimated spot rates.

(c) increase the potential costs of implementing any proposed narrow-scope amendments. Those potential costs relate in particular to:

(i) the assessment of whether observable rates meet the estimation objectives in paragraph 7; and

(ii) the disclosures that an entity should provide when a currency lacks exchangeability (see Agenda Paper 12E).

Other matters

Functional currency is that of a hyperinflationary economy

B7. An entity whose functional currency is that of a hyperinflationary economy applies IAS 29 *Financial Reporting in Hyperinflationary Economies*. IAS 29 specifies requirements that result in restating such an entity's financial statements in terms of the measuring unit current at the reporting date. As a consequence, the entity's financial statements reflect the effect of changing prices (in other words, inflation). Because of this, some say if an entity translates those financial statements into a presentation currency, the exchange rate used for translation should reflect only inflation—ie the entity should apply a rate estimated using a model with only inflation as an input.

B8. We recommend no specific requirements when exchangeability is lacking for a currency of a hyperinflationary economy. By requiring entities to faithfully reflect prevailing economic conditions and not prescribing how an entity estimates a spot rate, an entity would apply judgement in estimating the spot rate in those situations. We would generally expect inflation to be an important consideration in those circumstances.

[6] Applying those approaches, an entity would estimate the spot rate if the observable rates do not meet the estimation objectives set out in paragraph 7—in particular, if the entity assesses that those observable rates do not reflect faithfully reflect the economic conditions prevailing at the reporting date.

Indirect exchange mechanism

B9. We considered a situation in which an entity might not be able to directly exchange a local currency (X) for a particular foreign currency (Y). However, it might be able to:

(a) exchange the local currency (X) for another foreign currency (Z); and

(b) exchange that other foreign currency (Z) for the required foreign currency (Y).

B10. In this situation, we conclude the local currency (X) is exchangeable because the entity is able to exchange (indirectly) the local currency (X) for the foreign currency (Y). In this case, an entity would derive the applicable exchange rate by using the spot rates between (a) currencies X and Y, and (b) currencies Y and Z. Accordingly, we recommend no specific requirements in this respect.