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STAFF PAPER

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Project	IAS 21 — Extreme long-term lack of exchangeability		
Paper topic	Item for continuing consideration		
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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 particular circumstances that exist for many foreign operations in Venezuela.

2. We discussed this matter at the May 2018 IFRS Interpretations Committee (Committee) meeting, asking for Committee members' preliminary views on the matter and the best course of action to address it. In this paper, we have considered those preliminary views in recommending a way forward.

3. At the May 2018 meeting, we described the matter as one that arises when:

   (a) an 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.

4. The agenda paper then went on to explain that our research has indicated that, at least for some (if not many) Venezuelan operations, the lack of exchangeability with other currencies is so extreme that the foreign operation has not been able to access foreign currencies using the available legal exchange mechanisms. Committee members

confirmed that the findings from our research aligns with their experience. A number of Committee members and observers also suggested that, if the Committee is to address this matter, it should address only the very narrow and extreme circumstances of which we have been informed.

5. For these reasons, we have refined our description of the circumstances as follows (which we refer to as 'the matter' throughout this paper):
   (a) an entity translates the results and financial position of a foreign operation into its presentation currency;
   (b) the functional currency of the foreign operation is subject to a long-term lack of exchangeability with other currencies; and
   (c) the lack of exchangeability with other currencies is so extreme that the foreign operation has in effect been unable to access foreign currencies using a legal exchange mechanism.

6. We think this description is more accurate than was used in the initial part of the May 2018 agenda paper, and reflects a long-term lack of exchangeability that is extreme.

7. The objective of this paper is to:
   (a) provide the Committee with a summary of the matter;
   (b) present our analysis;
   (c) provide a summary of Committee members' preliminary views at the May 2018 meeting and our analysis of those views; and
   (d) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

8. This paper builds on the analysis in agenda paper 3 of the May 2018 Committee meeting—it does not repeat all the content of that paper and, instead, we provide references to that paper where appropriate. The May 2018 agenda paper can be found here.

Structure of the paper

9. This paper is structured as follows:
   (a) Background information (paragraphs 11-19);
   (b) Staff analysis (paragraphs 20-48);
   (c) Summary of Committee members' preliminary views and our analysis of those views (paragraphs 49-89);
   (d) Staff conclusion (paragraphs 90-95); and
   (e) Staff recommendation (paragraph 96).

10. This paper has two appendices:
    (a) Appendix A—Proposed wording of the tentative agenda decision; and
    (b) Appendix B—Extract from November 2014 *IFRIC Update*

Background information

11. IAS 21 includes requirements for the translation of the results and financial position of a foreign operation[1] into a reporting entity's presentation currency. Those requirements do not however include any explicit requirement on the exchange rate a reporting entity uses to translate the results and financial position of a foreign operation when there is a long-term lack of exchangeability between (i) the functional currency of the foreign operation and (ii) the presentation currency of the reporting entity.

12. 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.

[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.

13. Some stakeholders explained that the matter has become particularly extreme for Venezuelan foreign operations, whose functional currency is the Venezuelan Bolivar (VEF). In particular:

    (a) the jurisdictional authorities administer the exchangeability of VEF, and allocate foreign currencies to entities and individuals mainly through an auction-based mechanism. The jurisdictional authorities set an official exchange rate for VEF and thus the official exchange rate is not a free-floating rate. The exchangeability of VEF is subject to restrictions, the severity of which has increased over time.

    (b) entities have been unable for several years to exchange VEF to repatriate dividends or make investment-related payments. The exchangeability of VEF, limited in previous years, has been significantly reduced over the past year, to the extent that some foreign operations have been in effect unable to access foreign currencies.

    (c) the jurisdictional authorities have adjusted the official exchange rate but only sporadically, and the adjustments have not faithfully reflected the prevailing hyperinflationary[2] conditions in a timely manner.

    (d) 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.

    (e) 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.

    (f) the application of IAS 29 *Financial Reporting in Hyperinflationary Economies* has exacerbated the distortions described above. We illustrated

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

in Appendix C of the May 2018 agenda paper the possible distortions arising when the matter arises for a foreign operation with a functional currency that is the currency of a hyperinflationary economy.

14. Those stakeholders also explained that differences in reporting practices have arisen with respect to Venezuelan operations. Our research (described in Appendix B to the May 2018 agenda paper) identified three main reporting practices, supplemented with specific disclosures in the notes to the financial statements or additional information in the management commentary:

    (a) the use of an official exchange rate;

    (b) the use of an estimated exchange rate, adjusted to reflect inflation in Venezuela; and

    (c) the deconsolidation of Venezuelan operations.

Deconsolidation of foreign operations

15. Entities that have deconsolidated Venezuelan operations reported having done so applying IFRS 10 *Consolidated Financial Statements*. Paragraph B80 of IFRS 10 requires an entity to reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 of IFRS 10. In the May 2018 agenda paper, we noted however that IFRS 10 does not include any consolidation exception when the functional currency of an investee is subject to a long-term lack of exchangeability. This is because the existence of such circumstances do not necessarily preclude control[3].

16. If an entity has deconsolidated its interests in Venezuelan operations (and does not apply the equity method to those interests), those operations are unlikely to meet the definition of a foreign operation in IAS 21. In that case, the matter discussed in this paper no longer arises for that entity. Nonetheless, if the entity enters into VEF-

[3] 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.'

denominated transactions with those Venezuelan investees, the entity would still need to determine the exchange rate to apply in translating those VEF-denominated transactions into its functional currency.

Previous consideration by the Committee of the exchange rate to use for Venezuelan foreign operations

17. 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 entity[4].

18. In November 2014, the Committee decided not to add this matter to its agenda. The Committee's agenda decision (see Appendix B 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…

Previous consideration by the Board

19. Several respondents referred to the matter the Committee considered in 2014 in responding to the Board's 2015 Agenda Consultation. The Board considered those

[4] 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 B to this paper).

comments in May 2016, and decided not to add to its work plan a project on foreign currency translation.

Staff analysis

Translation into the presentation currency

20. 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.

21. Paragraphs 39 and 42 of IAS 21 specify that an entity translates:

    (a) the assets and liabilities of the foreign operation at the 'closing rate'; and

    (b) income and expenses of the foreign operation at:

        (a) 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

        (b) the closing rate.

What is the closing rate?

Main features of a closing rate

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

    > …Closing rate is the spot exchange rate at the end of the reporting period…
    >
    > …Spot exchange rate is the exchange rate for immediate delivery.
    >
    > …Exchange rate is the ratio of exchange for two currencies…

23. 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.

24. 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…[5]

25. 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 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 administered process created and directed by jurisdictional authorities—what we call 'administered 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.

Closing rate used to translate the results and financial position into the presentation currency

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

What is the exchange rate at the date of a transaction?

27. Paragraph 22 of IAS 21 describes the 'date of a transaction' as the date on which the transaction first qualifies for recognition in accordance with IFRS Standards.

[5] 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.

28. However, IAS 21 does not specify which exchange rate an entity uses at the date of a transaction. Although not explicitly stated in IAS 21, we think this rate would be the spot exchange rate (ie the exchange rate for immediate delivery) at the date of a transaction. This is because it is only the spot exchange rate that would reflect the exchange rate at that date.

Circumstances in which a currency is not exchangeable

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

29. 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.

30. IAS 21 does not say anything further about a temporary lack of exchangeability.

31. In addition, IAS 21 does not include any requirements for circumstances in which there is a long-term lack of exchangeability—ie a lack of exchangeability that is other-than-temporary as described in paragraph 26 of IAS 21.

What is a long-term lack of exchangeability?

A lack of exchangeability

32. 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.

33. In the case of administered 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 the entity could enter into an exchange transaction at the official exchange rate.

34. We note that a lack of exchangeability can arise in different forms. In the case of administered 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 the long term

35. 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.

36. 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 (or at the date of a transaction), thus preventing the reporting entity from observing a closing rate (or a rate at the date of the transaction); but

    (b) the exchangeability of the currency is restored after the end of the reporting period (or the date of the transaction) and before the date on which the financial statements are authorised for issue.

37. In this case, the entity applies as the closing rate (or the rate at the date of the transaction) the rate prevailing on the day when the exchangeability of the currency is restored.

38. The wording in paragraph 26 of IAS 21 supports this view. 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) before the date on which the entity's financial statements are authorised for issue.

39. Accordingly, we think a long-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 long-term lack of exchangeability of VEF

40. Our research highlighted the following regarding the exchangeability of VEF at present:

    (a) the legal supply of foreign currency in Venezuela is made only through administered mechanisms regulated and directed by the jurisdictional authorities.

    (b) many Venezuelan foreign operations have been unable to obtain foreign currency to make investment-related payments (such as dividend payments to foreign investors) 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.

    (c) more generally, the exchangeability of VEF for any purpose is extremely limited, becoming increasingly so during 2017 and into 2018. 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.

41. It appears that VEF is subject to a long-term lack of exchangeability. In the light of (a) the factors we identified in paragraph 34 of this paper and (b) the restrictions that apply to the exchangeability of some other currencies, this lack of exchangeability is extreme. It is so severe that it has become increasingly difficult, even impossible, for some foreign operations to observe directly any exchange transactions that might provide an exchange rate for immediate delivery of VEF for another currency.

42. These very specific circumstances, arising for particular Venezuelan foreign operations, have two implications when determining the exchange rate at which to translate the results and financial position of those Venezuelan foreign operations:

    (a) the official exchange rate of VEF may not meet the definition of a spot exchange rate in IAS 21. In our view, this would be the case when a foreign operation is unable to exchange VEF for other currencies using a legal exchange mechanism, and thus is unable to settle any exchange transaction at the official exchange rate with immediate delivery—ie in these circumstances, the official exchange rate is not 'the exchange rate for immediate delivery' for that foreign operation.

    (b) in the absence of any directly observable spot exchange rate, an entity would estimate the closing rate (ie the spot exchange rate at the end of the reporting period).

Estimating the spot exchange rate

43. We would expect an entity to consider all relevant factors in estimating the spot exchange rate.

44. In particular, we would expect those factors to include the effects of inflation because:

    (a) economic literature indicates that there is expected to be a relationship between exchange rates and inflation (see Appendix D of the May 2018 agenda 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.

45. Estimating the spot exchange 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.

46. Paragraphs 126-133 of IAS 1 include requirements accompanying the disclosure principle in paragraph 125 of IAS 1.

Disclosure requirements

47. We think there are a number of disclosure requirements (in addition to those in paragraphs 125-133 of IAS 1 mentioned above) that are likely to apply when there is a long-term lack of exchangeability that is extreme. For example, paragraphs 117-124 of IAS 1 requires an entity to disclose its significant accounting policies, and judgements made in applying those accounting policies that have the most significant effect on the amounts recognised in the financial statements.

48. In addition, we note the requirements in:

    (a) paragraphs 10 and 13 of IFRS 12 *Disclosure of Interests in Other Entities* to disclose the nature and extent of significant restrictions on an entity's ability to access or use assets, and settle liabilities, of the group; and

    (b) paragraphs 20 and 22 of IFRS 12 to disclose the nature and extent of significant restrictions on the ability of joint ventures or associates to transfer funds to an entity.

Question 1 for the Committee
Question 1—Does the Committee agree with our analysis of the requirements in IFRS Standards, summarised in paragraphs 20-48 of this paper? We note that the next section of the paper discusses Committee members' comments at the May 2018 meeting, including those relating to our analysis. Committee members may find it helpful to read the next section in considering Question 1.

Summary of Committee members' preliminary views and our analysis of those views

49. At the May 2018 Committee meeting, we sought Committee members' preliminary views on the matter. Committee members' main comments, together with our analysis, are presented below.

The scope of the matter and differences in reporting practices

Committee members' comments

50. Some Committee members said that the differences in reporting practices identified (see paragraph 14 of this paper) reflect differences in the facts and circumstances for different Venezuelan foreign operations. Accordingly, those members questioned the existence of diverse reporting methods and expressed concerns about the Committee adopting a 'one-size-fits-all' approach for all Venezuelan operations.

Staff analysis

51. The matter that we were informed of relates to the extreme circumstances that currently exit in Venezuela for at least some Venezuelan foreign operations with a functional currency of VEF. In explaining the matter, the May 2018 agenda paper may have unduly focussed on Venezuela as a whole, implying that our analysis of IAS 21 would apply to *all* Venezuelan operations.

52. That is not our intention. We agree that all entities with Venezuelan operations are not in the same situation. For example, the fact that some entities have deconsolidated Venezuelan operations (and thus have concluded that they no longer control those operations applying IFRS 10) means that different facts and circumstances exist for those entities than for entities that continue to consolidate Venezuelan operations.

53. Paragraphs 78-89 of this paper discuss the possible ways that the Committee might address the matter. If the Committee were to address it by explaining the application of the existing requirements in IAS 21 in an agenda decision, then we would suggest that the agenda decision describe the narrow and extreme set of circumstances of which we were informed and on which we based our analysis—in particular, the fact that the lack of exchangeability is so extreme that the foreign operation has in effect been unable to access foreign currencies using a legal exchange mechanism. Appendix A to this paper outlines the draft wording of a tentative agenda decision. Venezuela itself would not be mentioned in the agenda decision—in that way, the agenda decision would apply to any entity in circumstances in which there is a long-term lack of exchangeability that is extreme, but not for example to Venezuelan operations not facing such a long-term lack of exchangeability.

54. In terms of whether to address the matter, we continue to see benefit in the Committee addressing it. Our outreach indicated that entities are uncertain about whether and when they can or should estimate an exchange rate applying IAS 21. Our outreach also suggests that at least some entities in similar situations are applying different reporting practices regarding their Venezuelan operations—ie some are using an official exchange rate whereas others are using an estimated exchange rate in translating the results and financial position of Venezuelan foreign operations.

Other accounting questions that arise regarding Venezuelan operations

Committee members' comments

55. Some Committee members observed that other accounting questions might arise for entities with Venezuelan operations in the light of the current economic conditions in Venezuela—for example, determining whether the entity continues to control

Venezuelan operations and determining the functional currency of the foreign operation.

56. Although agreeing that those accounting questions may arise, a few Committee members and observers said that the Committee should not expand the scope of any work undertaken to address those questions. In their view, IFRS Standards provide an adequate basis for an entity to determine (a) whether it controls an investee and (b) the functional currency of its operations. They suggested focussing narrowly on the matter of the exchange rate to use in circumstances in which there is a long-term lack of exchangeability that is extreme.

Staff analysis

57. We agree with Committee members and observers suggesting that any further work should focus narrowly on the exchange rate to use in the particular circumstances discussed in this paper. Our outreach and research did not highlight the need for further work by the Board or Committee with respect to those other accounting questions. An entity's assessment of those other accounting questions is separate from its determination of the exchange rate to use to translate the results and financial position of its foreign operations.

Interaction of any further work with the November 2014 agenda decision

Committee members' comments

58. Some Committee members and observers commented on the interaction of any further work (in particular, publishing a new agenda decision) with the November 2014 agenda decision regarding a longer-term lack of exchangeability. A few were concerned that publishing a new agenda decision might contradict what was said in the November 2014 agenda decision (in particular, the observation that a longer-term lack of exchangeability is not addressed by the requirements in IAS 21, and so it is not entirely clear how IAS 21 applies in such situations). When there is a longer-term lack of exchangeability, those Committee members said in their view the use of an estimated rate is one possible way to apply IAS 21 but may not be the only way to apply it.

Staff analysis

59. The November 2014 agenda decision (reproduced in Appendix B to this paper) mentions strict foreign exchange controls that restrict the amount of local currency that can be exchanged, and refers to this as ‘a longer-term lack of exchangeability’. That agenda decision does not provide further information about the effects of those foreign exchange controls on a foreign operation’s ability to access foreign currencies through a legal exchange mechanism.

60. With only that description—restrictions on the amount of local currency that can be exchanged—we would not conclude on whether an entity estimates the spot exchange rate applying IAS 21. Even if there are restrictions on the amount of currency that can be exchanged, a foreign operation may be able to access foreign currencies through a legal exchange mechanism and, thus, a spot exchange rate may be directly observable. Such a situation is different from the circumstances discussed in this paper.

61. The economic conditions in Venezuela have deteriorated since 2014 and have now resulted in foreign exchange restrictions that are much more severe than they were in 2014. Our research indicated that the supply of foreign currency has decreased significantly over recent years, and in particular in recent months, to the extent that many Venezuelan operations have in effect been unable to exchange VEF for foreign currency for any purpose. In other words, there has been a substantive change in the facts and circumstances surrounding many Venezuelan operations since 2014, and this change has resulted in a long-term lack of exchangeability that is extreme. Consequently, those extreme circumstances:

    (a) change the matter to be considered by the Committee compared to the matter discussed in 2014, and thus

    (b) entail a different technical analysis.

62. Accordingly, if the Committee undertakes further work on the matter discussed in this paper, we do not anticipate any conflict with the 2014 agenda decision—this is because it is a different matter from the one considered in 2014 and could be described as such.

The use of an estimated exchange rate

Committee members' comments

63. Overall, Committee members did not express any major disagreement with our technical analysis. However, a few Committee members said the requirements in IAS 21 are not clear on whether an entity estimates the exchange rate in the circumstances described in this paper. In their view, this justifies undertaking standard-setting.

64. Some of those Committee members were also concerned about the implication from our analysis that the official exchange rate of VEF does not meet the definition of a spot exchange rate in IAS 21. Those Committee members noted that many entities still use the official exchange of VEF to translate the results and financial position of Venezuelan foreign operations into their presentation currency applying IAS 21.

65. In estimating the spot exchange rate, Committee members agreed that an entity is likely to include the effects of inflation. However they noted that entities would consider all relevant factors in the estimation. One member said the estimation should maximise inputs from third parties.

Staff analysis

66. We acknowledge that IAS 21 does not make any explicit reference to the use of an estimated exchange rate. We note however that neither does IAS 21 refer to 'official' or 'observable' exchange rates. IAS 21 requires the use of the spot exchange rate—ie the exchange rate for immediate delivery. We think our analysis reflects that definition. In all but the most extreme circumstances, the exchange rate for immediate delivery would be directly observable because exchange transactions occur. The rate applied to those transactions would be either a rate observed on a market or a rate set by jurisdictional authorities. However, if a foreign operation is unable to be a party to a legal exchange transaction (as is the case in the circumstances discussed in this paper), then it is not possible to directly observe the spot exchange rate. Because IAS 21 requires the use of the spot exchange rate, in our view in the absence of a directly observable rate an entity estimates that rate.

67. Consistent with the analysis above, we think an official exchange rate does not meet the definition of a spot exchange rate when the circumstances discussed in this paper

exist. However, this does not necessarily mean that the official exchange rate of VEF never meets the definition of a spot exchange rate—our view is simply that it does not meet that definition when an entity is unable to transact at that rate using a legal exchange mechanism.

68. Our research indicates that the application difficulties of which we were informed arise because of the use of an official exchange rate. Because in all but the most extreme situations, there is typically an observable spot exchange rate that may be an official administered rate, some entities were unsure about whether they could move away from applying an official rate even in those extreme circumstances discussed in this paper.

69. We think any further work that the Committee might undertake would provide new information for entities in those circumstances in which a long-term lack of exchangeability is extreme.

70. Regarding the estimation process, we agree that an entity would need to consider all relevant factors in estimating the spot exchange rate. We think the Committee could say little about how to estimate the exchange rate in an agenda decision based on the requirements in IAS 21. However if standard-setting is undertaken, it could develop requirements in this respect.

Exchangeability that is temporarily lacking (paragraph 26 of IAS 21)

Committee members' comments

71. One Committee member disagreed with our analysis of exchangeability that is temporarily lacking (discussed in paragraphs 36-38 of this paper). In the Committee member's view, the use of the first subsequent rate at which exchanges could be made may not be the appropriate rate to use in all instances that exchangeability is restored before the financial statements are authorised for issue, especially if the date of authorisation is long after the reporting date and the currency is of a hyperinflationary economy.

Staff analysis

72. We discuss exchangeability that is temporarily lacking in the context of describing what we mean by a long-term lack of exchangeability. We think the requirements in

paragraph 26 of IAS 21 that require the use of 'the first subsequent rate at which exchanges could be made' (without specifying any time period for that first subsequent rate) require the use of an observable exchange rate available when exchangeability is restored, even if that rate is observable some time after the reporting date.

73. Having said that, it may not be necessary to explain the meaning of 'temporarily lacking' in paragraph 26 of IAS 21 to address the matter discussed in this paper.

74. If the Committee were to decide to publish an agenda decision, the circumstances described in the agenda decision could say simply that exchangeability is not temporarily lacking as described in paragraph 26 of IAS 21. The circumstances are so extreme that exchangeability has not been restored between the reporting date and the date at which financial statements are authorised for issue, and thus there is no difference in our views and those of the Committee member for the matter discussed in this paper.

75. Nonetheless, if standard-setting is undertaken, we think the definition of a long-term lack of exchangeability should be discussed further.

Immediate delivery

Committee members' comments

76. One Committee member was concerned about a narrow reading of 'immediate delivery'—ie reading 'immediate' as a synonym of 'instantaneous'—in situations in which the exchangeability of a currency is subject to an administrative process that might result in an entity obtaining foreign currency only at the end of this process.

Staff analysis

77. We agree that the reading of 'immediate delivery' should consider how the exchangeability of a currency is operated. We note that many jurisdictional authorities provide market participants with access to foreign currencies through legal mechanisms—such as fixing sessions, foreign exchange allocation systems, etc. Those mechanisms may entail some administrative process, which means that entities do not obtain instantaneous access to foreign currencies. We think such an administrative process does not, in isolation, mean that there is no observable spot

exchange rate. In our view, the notion of 'immediate delivery' should be understood taking into account how the exchangeability of a currency is operated.

Possible ways to address the matter

Committee members' comments

78. Committee members expressed mixed views on how best to address the matter.

79. Some Committee members were not convinced that the Committee should undertake further work, explaining that:

    (a) the facts and circumstances are so specific that the Committee might fail to be helpful to entities;

    (b) entities have already applied their judgement. Accordingly, any further action could be disruptive; and

    (c) disclosures are crucial in understanding the particular facts and circumstances. If appropriately designed, disclosures might effectively address the practical difficulties encountered.

80. In contrast, some Committee members recommended narrow-scope standard-setting. Those members generally said that the requirements in IAS 21 are not clear on whether an entity uses an estimated exchange rate in the circumstances discussed in the May 2018 agenda paper. They also referred to possible conflicts with the November 2014 agenda decision, as discussed above in paragraph 58 of this paper. One Committee member observed that the situation in Venezuela reflects a long-standing matter of concern, which arises from time to time for particular jurisdictions. When it arises, the matter is urgent. In this Committee member's view, it would be best to work on a longer-term solution that would then be in place when the situation arises in the future, even if that solution might not be in place in time to resolve the difficulties encountered at present in Venezuela.

81. A few Committee members suggested publishing a new agenda decision, noting that it would be an efficient way of responding to the matter. One of those Committee members said an agenda decision should outline the use of an estimated exchange rate as one possible way of applying IAS 21.

82. Those who supported either undertaking standard-setting or publishing a new agenda decision said the scope of any further work should be narrow. Those Committee members would not want any further work to be understood as permitting the use of an estimated exchange rate in situations in which it would be inappropriate to use such a rate (for example, when there is an observable spot exchange rate).

Staff analysis

Should the Committee undertake any further action?

83. In paragraphs 59-60 of the May 2018 agenda paper, we considered undertaking no further action.

84. In our view, the drawbacks of this option exceeds its merits. In particular, as explained in paragraph 54 of this paper, there are differences in reporting practices in relation to the matter, and entities have informed us about difficulties that they are facing in applying the requirements in IAS 21 in this situation.

85. Accordingly, we think the Committee should consider either publishing an agenda decision or recommending standard-setting.

Publish an agenda decision or recommend narrow-scope standard setting?

86. In our view, the scope of the question to be addressed may strongly influence the course of action that the Committee might take or recommend:

    (a) should the Committee wish to address the matter of a long-term lack of exchangeability that is extreme—ie the matter identified to us and discussed in this paper, then we think publishing an agenda decision is the appropriate course of action. In particular, we think the technical analysis outlined in paragraphs 20-48 of this paper could underpin an agenda decision. In our view, the existence of extreme circumstances means that the requirements in IAS 21 provide an adequate basis so that standard-setting is not needed to respond to the matter discussed in this paper.

    (b) should the Committee wish to address the wider matter of a long-term lack of exchangeability that is *not* so extreme—ie a longer-term lack of exchangeability as considered in the November 2014 agenda Decision, then

the Committee should consider recommending narrow-scope standard-setting.

87. If the Board or Committee were to undertake narrow-scope standard-setting, we think any standard-setting action would need to consider the following topics directly related to a long-term lack of exchangeability:

(a) the features identifying a lack of exchangeability;

(b) the definition of a long-term lack of exchangeability;

(c) the factors to consider in estimating a spot exchange rate; and

(d) any disclosures requirements.

88. In addition, a narrow-scope standard-setting project would be likely to require consideration of some topics indirectly related to the matter, in particular whether requirements are needed when there is:

(a) a long-term lack of exchangeability in situations in which an entity translates foreign currency transactions into its functional currency; and

(b) a temporary lack of exchangeability in situations in which an entity uses a presentation currency other than its functional currency.

89. Although narrow in scope, we think that any standard-setting project would not necessarily be straightforward and would take some time to complete.

Staff conclusion

90. Having considered the preliminary views of Committee members and our research on the matter, we recommend publishing an agenda decision that would address the narrow and extreme circumstances discussed in this paper. We think the technical analysis set out in paragraphs 20-48 of this paper could underpin explanatory material on the exchange rate an entity uses in circumstances in which there is a long-term lack of exchangeability that is extreme.

91. We can see benefits in undertaking a narrow-scope standard-setting project that would address the wider matter of a long-term lack of exchangeability that is not so extreme.

This would provide clarity as to the exchange rate to be used for a wider set of circumstances than only the extreme circumstances discussed in this paper. As noted by Committee members, questions arise in this respect from time to time—when they do, they are urgent and there would be benefits to having requirements in IAS 21 that provide greater clarity when those questions arise.

92. In saying that, the Board considered in 2016 whether to add a project to its work plan on foreign currency translation, and decided not to do so. The matter of a long-term lack of exchangeability considered by the Committee in 2014 was part of the Board's consideration in 2016. To recommend standard-setting at this time, we think we would need to identify and explain why such a project should be a higher priority than other active or pipeline projects on the Board's work plan—ie we would need to explain what has changed in the past two years to suggest a change in project priorities.

93. Appendix A to this paper outlines our proposed wording of the tentative agenda decision. We have included the following aspects, which we think might address a number of Committee members' comments at the May 2018 meeting:

    (a) a description of a long-term lack of exchangeability that is extreme, including in particular that a foreign operation has been unable to access foreign currencies using a legal exchange mechanism. We think this wording indicates that the assessment is made by each entity based on the relevant facts and circumstances; the agenda decision would not be saying that all entities in any particular jurisdiction are in the same situation. It also explains just how extreme the circumstances need to be in order to conclude that an entity uses an estimated exchange rate applying IAS 21.

    (b) an assumption that an entity has applied appropriately other requirements in IFRS Standards—we think this assumption is helpful in indicating that the determination of the functional currency and control of the foreign operation are both important considerations in circumstances in which there is a long-term lack of exchangeability that is extreme. However, that is not the subject of this agenda decision and those assessments are separate from the determination of the spot exchange rate.

(c) the continuous reassessment of the circumstances to determine whether there continues to be a long-term lack of exchangeability that is extreme—this outlines that the Committee would be concluding on the use of an estimated exchange rate only in those extreme circumstances.

(d) the applicable disclosure requirements.

94. We do not recommend amending or rescinding the November 2014 agenda decision (reproduced in Appendix B to this paper). This is because the 2014 agenda decision addresses a matter that is similar, but *not* identical, to the matter discussed in this paper, as explained in paragraphs 58-62 of this paper.

Is it necessary to add to or change IFRS Standards to improve financial reporting?[6]

95. Based on our analysis, we think the requirements in IAS 21 provide an adequate basis for an entity to determine the exchange rate to use in translating into its presentation currency the results and the financial position of a foreign operation when there is a long-term lack of exchangeability that is extreme.

Staff recommendation

96. On the basis of our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the Due Process Handbook, we recommend that the Committee not add this matter to its standard-setting agenda. Instead, we recommend that it publish an Agenda Decision that explains how an entity applies the applicable requirements in IAS 21.

Questions 2 and 3 for the Committee
Question 2—Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda?
Question 3—Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

[6] Paragraph 5.16(b) of the *Due Process Handbook*.

Appendix A—Proposed wording of the tentative agenda decision

IAS 21 *The Effects of Changes in Foreign Exchange Rates*—Extreme long-term lack of exchangeability

The Committee considered the matter of the exchange rate to use when applying IAS 21 in the following circumstances (ie circumstances that exist when there is a long-term lack of exchangeability that is extreme):

(a) the entity translates the results and financial position of a foreign operation into its presentation currency;

(b) the functional currency of the foreign operation is subject to a long-term lack of exchangeability with other currencies—ie the exchangeability is not temporarily lacking as described in paragraph 26 of IAS 21 and has not been restored after the end of the reporting period; and

(c) the lack of exchangeability with other currencies is so extreme that the foreign operation has in effect been unable to access foreign currencies using a legal exchange mechanism.

In analysing the matter, the Committee assumed that the entity has applied appropriately other requirements in IFRS Standards, in particular those in IAS 21 regarding the functional currency and those in IFRS 10 *Consolidated Financial Statements* regarding control and its reassessment.

The Committee observed that an entity translates the results and financial position of a foreign operation into its presentation currency applying the requirements in paragraphs 39 and 42 of IAS 21. Those paragraphs specify that an entity translates:

(a) the assets and liabilities of the foreign operation at the closing rate; and

(b) income and expenses of the foreign operation at 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 at the closing rate.

The closing rate

Paragraph 8 of IAS 21 defines (a) the 'closing rate' as the spot exchange rate at the end of the reporting period; and (b) the 'spot exchange rate' as the exchange rate for

immediate delivery. In the light of those definitions, the Committee concluded that the closing rate is the rate to which an entity would have immediate access through a legal exchange mechanism at the end of the reporting period.

In circumstances in which there is a long-term lack of exchangeability that is extreme, the Committee noted that the foreign operation is unable to exchange its functional currency for other currencies using a legal exchange mechanism. Accordingly, the foreign operation is unable to be a party to a legal exchange transaction and, thus, the spot exchange rate is not directly observable. In those circumstances, the Committee concluded that an entity estimates the spot exchange rate—and hence the closing rate–– taking into account all relevant factors.

The exchange rates at the dates of the transactions

Consistent with the analysis above, in circumstances in which there is a long-term lack of exchangeability that is extreme (and the functional currency of the foreign operation is not the currency of a hyperinflationary economy), an entity also estimates the exchange rates at the dates of the transactions in applying paragraph 39(b) of IAS 21.

Continuous assessment of facts and circumstances

The Committee observed that in circumstances in which there is a long-term lack of exchangeability that is extreme, economic conditions are in general constantly evolving. An entity therefore reassesses at each reporting date whether those particular circumstances still exist and, thus, whether it continues to estimate the closing rate and, if applicable, the exchange rates at the dates of the transactions.

Disclosure requirements

An entity is required to provide information that is relevant to an understanding of an entity's financial statements (paragraph 112 of IAS 1 *Presentation of Financial Statements*). The Committee noted the following disclosure requirements that may be relevant to an understanding of an entity's financial statements in circumstances in which there is a long-term lack of exchangeability that is extreme:

(a) significant accounting policies, and judgements made in applying those policies that have the most significant effect on the amounts recognised in the financial statements (paragraphs 117–124 of IAS 1);

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

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

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to translate into its presentation currency the results and financial position of a foreign operation when there is a long-term lack of exchangeability that is extreme. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—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).