STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Lack of exchangeability (IAS 21)**
Paper topic	Cover memo and overall approach

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Introduction and purpose

1. At its June and September 2018 meetings, the IFRS Interpretations Committee (Committee) considered the determination of the exchange rate an entity uses in particular circumstances to translate the results and financial position of a foreign operation into its presentation currency applying IAS 21 *The Effects of Changes in Exchange Rates*. As part of its analysis of that matter, the Committee observed that IAS 21 does not include explicit requirements on the exchange rate a reporting entity uses when the spot exchange rate (as defined in IAS 21) is not observable. Accordingly, the Committee decided to research possible narrow-scope standard-setting aimed at addressing this matter.

2. The objective of this meeting is to explore possible standard-setting options to address the matter.

3. We are not asking the Committee to make any decisions. We think it would be helpful for the Committee to first discuss the matter and provide advice and feedback on our preliminary views before we then recommend a way forward. We will bring a paper to a future Committee meeting that would include a recommendation for the Committee's consideration.

Structure

4. This cover memo includes:

   (a) background information; and

   (b) our approach.

5. This paper has two appendices:

   (a) Appendix A—Agenda Decision published in September 2018; and

   (b) Appendix B—Comments on Committee's decision to research possible narrow-scope standard setting.

6. Agenda Papers 8A and 8B provide further information about our research. In particular:

   (a) Agenda Paper 8A includes our analysis of, and preliminary views on, defining 'lack of exchangeability' (both temporary and long-term); and

   (b) Agenda Paper 8B includes our analysis of, and preliminary views on, requirements that could apply when a currency is subject to either a temporary or long-term lack of exchangeability.

Background information

7. At its meetings in June and September, the Committee considered the determination of the exchange rate an entity uses to translate the results and financial position of a foreign operation into its presentation currency applying IAS 21. The Committee considered this matter in the following circumstances:

   (a) the exchangeability of the foreign operation's functional currency with other currencies is administered by jurisdictional authorities. This exchange mechanism incorporates the use of an exchange rate set by the authorities (official exchange rate).

   (b) the foreign operation's functional currency 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; it has not been restored after the end of the reporting period.

(c) the lack of exchangeability with other currencies has resulted in the foreign operation being unable to access foreign currency using the exchange mechanism described in paragraph 7(a) above.

8. The Committee observed that those circumstances currently exist in Venezuela. The Committee discussed whether, in those circumstances, an entity is required to use an official exchange rate in applying IAS 21. The Committee published an agenda decision explaining how an entity applies IAS 21 in assessing whether it uses the official exchange rate to translate into its presentation currency the results and financial position of a foreign operation. Appendix A to this paper reproduces the agenda decision for ease of reference.

9. In addition, the Committee decided to research possible narrow-scope standard-setting aimed at addressing situations in which an entity might conclude that the spot exchange rate is not observable. Some respondents to the tentative agenda decision commented on the Committee's decision to undertake research—Appendix B to this paper reproduces these comments.

Our approach

10. In this section, we outline our approach to the research, and any boundaries within which we conducted that research.

11. We first considered how to address the matter. We identified two possible approaches:

(a) develop requirements on the exchange rate an entity uses in the limited circumstances described in the agenda decision (ie the circumstances listed above in paragraph 7) [Alternative A]; or

(b) consider more broadly when a lack of exchangeability could arise and develop requirements on the exchange rate an entity uses in those circumstances [Alternative B].

12. Alternative A would involve developing requirements on the exchange rate an entity applies only in the circumstances outlined in paragraph 7. Accordingly, this alternative would not define a lack of exchangeability per se, nor would it consider requirements that entities could apply in other situations in which there might be some lack of exchangeability but which are not as extreme as those covered by the circumstances listed in paragraph 7 of this paper.

13. Alternative A would (a) result in a targeted narrow-scope amendment to IAS 21 that would resolve a known problem in practice, and (b) be relatively simple to develop.

14. However, the benefits of this alternative would be limited. This is because Alternative A would address only extreme situations which do not occur frequently (even though they currently exist in Venezuela). For example, those circumstances might be reflective of the situation that currently exists in Venezuela but might have been too restrictive to capture the situation that had existed in that jurisdiction before 2018. In 2014, the circumstances in that jurisdiction were not as extreme as those that currently exist but were sufficiently severe to trigger a submission to the Committee.

15. Accordingly, we suggest considering Alternative B—ie consider more broadly what constitutes a lack of exchangeability and develop requirements on the exchange rate an entity uses in those circumstances.

16. If the Committee agrees with our preliminary view of considering Alternative B, it would be necessary to:

    (a) assess what constitutes exchangeability and, thus, a lack of exchangeability (discussed in Agenda Paper 8A); and

    (b) develop requirements that would apply in those circumstances (discussed in Agenda Paper 8B).

17. Any definition of a lack of exchangeability needs to be sufficiently precise and well defined so that entities would not inappropriately apply to other situations the requirements in that situation.

Boundaries within which we conducted our research

Narrow-scope project

18. Any requirements developed on this matter should be in the context of a narrow-scope project. We have been informed that this matter could arise in several jurisdictions and should be dealt with in a timely manner. We also think it is possible to usefully and efficiently propose some targeted narrow-scope amendments to IAS 21 that would address the exchange rate an entity uses when there is a lack of exchangeability.

19. We would propose that this project should not reconsider any fundamental requirements in IAS 21 or consider addressing other aspects of IAS 21. This is because:

    (a) as part of its 2015 *Agenda Consultation* the Board decided not to undertake further work on IAS 21. We have not received new information that indicates the Board should revisit this decision;

    (b) addressing other aspects of IAS 21 would significantly broaden the scope of any project and would limit the Committee's ability to respond to this matter in a timely and efficient manner; and

    (c) the Committee's discussion at its meetings in June and September 2018 emphasised that any possible standard-setting on this matter should be narrow in scope.

Limiting the scope to hyperinflationary economies

20. Some might suggest limiting the scope of any proposed amendments to entities within the scope of IAS 29 *Financial Reporting in Hyperinflationary Economies*. We do not agree. This is because the situation of a spot exchange rate not being observable does not arise only in jurisdictions that are hyperinflationary (see paragraph C3 of Appendix C to Agenda Paper 3 prepared for the May 2018 Committee meeting for more information on this matter).

Preliminary view

21. Based on our analysis in paragraphs 10–20 of this paper, our preliminary view is that any possible standard-setting should:

    (a) consider when a lack of exchangeability could arise and develop requirements on the exchange rate an entity applies in those circumstances; and

    (b) not reconsider any fundamental requirements in IAS 21 or consider addressing other aspects of IAS 21.

Question for the Committee
Does the Committee have any advice or feedback on our analysis and preliminary view in this agenda paper?

Appendix A—Agenda Decision published in September 2018[1]

Determination of the exchange rate when there is a long-term lack of exchangeability (IAS 21 The Effects of Changes in Foreign Exchange Rates*)*

The Committee considered the determination of the exchange rate an entity uses to translate the results and financial position of a foreign operation into its presentation currency applying IAS 21. The Committee considered this matter in the following circumstances:

(a) the exchangeability of the foreign operation's functional currency with other currencies is administered by jurisdictional authorities. This exchange mechanism incorporates the use of an exchange rate(s) set by the authorities (official exchange rate(s)).

(b) the foreign operation's functional currency 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; it has not been restored after the end of the reporting period.

(c) the lack of exchangeability with other currencies has resulted in the foreign operation being unable to access foreign currency using the exchange mechanism described in (a) above.

The Committee observed that those circumstances currently exist in Venezuela.

The Committee discussed whether, in those circumstances, an entity is required to use an official exchange rate(s) in applying IAS 21.

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 require an entity to translate:

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

[1] Reproduced from September 2018 IFRIC Update.

(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 and the rates at the dates of the transactions

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 access at the end of the reporting period through a legal exchange mechanism.

Accordingly, the Committee observed that in the circumstances described above an entity assesses whether the official exchange rate(s) meets the definition of the closing rate—ie is it the rate to which the entity would have access at the end of the reporting period? Similarly, if the foreign operation's functional currency is not the currency of a hyperinflationary economy, the entity also assesses whether the official exchange rate(s) represents the exchange rates at the dates of the transactions in applying paragraph 39(b) of IAS 21.

Continuous assessment of facts and circumstances

In the circumstances described above, economic conditions are in general constantly evolving. Therefore, the Committee highlighted the importance of reassessing at each reporting date whether the official exchange rate(s) meets the definition of 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 highlighted the importance of disclosing relevant information in the circumstances described above. In particular, the Committee observed that the following disclosure requirements may be relevant to an understanding of an entity's financial statements:

(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 assess whether, in the circumstances described above, it uses the official exchange rate(s) to translate into its presentation currency the results and financial position of a foreign operation. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

Appendix B—Comments on Committee's decision to research possible narrow-scope standard setting[2]

46. The ANC, the ASBJ, Deloitte and KPMG commented on the Committee's decision to research possible narrow-scope standard setting to address the exchange rate an entity uses when the spot exchange rate is not observable.

47. The ASBJ suggests that the Board (i) amend IAS 21 to set out requirements specifying the exchange rate an entity uses when there is a long-term lack of exchangeability; (ii) define what a longer-term lack of exchangeability is; and (iii) require specific disclosures.

48. KPMG suggests that the Committee develop an Interpretation to clarify (i) which exchange rate an entity uses when there is a long-term lack of exchangeability, (ii) the circumstances in which there is a long term lack of exchangeability, and (iii) how an entity determines an estimated exchange rate.

49. Deloitte recommends that any standard-setting address currency restrictions in a holistic manner, including the circumstances in which the exchangeability of a currency is restricted (but still occurring) and those in which a currency is not exchangeable at all.

50. The ANC questions whether the research should be limited to the requirements in IAS 21 or should also consider how the matter affects other IFRS Standards.

[2] Reproduced from paragraphs 46–50 of Agenda Paper 10 for the Committee's September 2018 meeting.