STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Translating a Hyperinflationary Foreign Operation (IAS 21 and IAS 29)**
Paper topic	Initial consideration—Cumulative Exchange Differences arising before a Foreign Operation becomes Hyperinflationary

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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the application of IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IAS 29 *Financial Reporting in Hyperinflationary Economies*. The submitter asks how a reporting entity—with a non-hyperinflationary presentation currency—presents the cumulative amount of exchange differences that have arisen from the translation of a foreign operation before the foreign operation becomes hyperinflationary.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information (paragraphs 5–18);

   (b) outreach and additional research performed (paragraphs 20–25);

   (c) staff analysis (paragraphs 25–42); and

   (d) staff recommendation (paragraphs 43–44).

4. This paper also includes one appendix: Appendix A—Proposed wording of the tentative agenda decision.

Background information

The matter

5. In the fact pattern described in the submission, a reporting entity:

   (a) prepares consolidated financial statements, and presents those financial statements in a non-hyperinflationary presentation currency;

   (b) has a hyperinflationary foreign operation; and

   (c) in preparing its consolidated financial statements, translates the results and financial position of the hyperinflationary foreign operation into its presentation currency.

Presenting exchange differences on translation of a non-hyperinflationary foreign operation

6. The requirements in paragraph 39 of IAS 21 apply when:

   (a) an entity uses a presentation currency other than the functional currency; and

   (b) the functional currency is not hyperinflationary.

7. Paragraph 39 states (emphasis added):

> The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:
>
> (a) assets and liabilities for each statement of financial position presented (ie including comparatives) shall be translated at the closing rate at the date of that statement of financial position;
>
> (b) income and expenses for each statement presenting profit or loss and other comprehensive income (ie including comparatives) shall be translated at exchange rates at the dates of the transactions; and
>
> (c) *all resulting exchange differences shall be recognised in other comprehensive income*.

8. Paragraph 41 of IAS 21 requires an entity to present the cumulative amount of the exchange differences in a separate component of equity until disposal of the foreign operation.

9. Paragraphs 44–47 of IAS 21 apply when a reporting entity translates the results and financial position of a foreign operation. Paragraph 44 requires the entity to also apply paragraph 38–43 of IAS 21 in translating the foreign operation. Accordingly, the reporting entity (a) presents in other comprehensive income (OCI) any exchange differences arising from translating a non-hyperinflationary foreign operation; and (b) accumulates these differences in a separate component of equity. For ease of reference, this paper refers to this component of equity as the pre-hyperinflation translation reserve.

10. The exchanges differences presented in OCI reflect the effect of changes in exchange rates on the reporting entity's net investment in the foreign operation—in particular, the retranslation of its net investment from the opening to the closing rate.

The question

11. The submitter asks how a reporting entity presents any pre-hyperinflation translation reserve when its foreign operation first becomes hyperinflationary. Specifically, the submitter asks whether, at the beginning of the first period during which the foreign operation becomes hyperinflationary, the reporting entity:

    (a) reclassifies within equity the pre-hyperinflation translation reserve—ie the reporting entity transfers to a component of equity (not subsequently reclassified to profit or loss) the exchange differences relating to the foreign operation accumulated in the pre-hyperinflation translation reserve (View A); or

    (b) retains in that separate component of equity the exchange differences relating to the foreign operation accumulated in the pre-hyperinflation translation reserve (View B).

12. Paragraph 48 of IAS 21 requires an entity to reclassify from equity to profit or loss any pre-hyperinflation translation reserve on disposal (or partial disposal) of a foreign operation. Accordingly:

    (a) applying View A, the reporting entity would not have any amounts in its pre-hyperinflation translation reserve to reclassify to profit or loss on disposal of the foreign operation.

    (b) applying View B, the reporting entity would reclassify to profit or loss amounts in its pre-hyperinflation translation reserve on disposal of the foreign operation.

13. The submission (reproduced in Appendix A to Agenda Paper 4) provides further details on these views.

When does the question arise?

14. The submitter explains that the question does not arise when the reporting entity elects to present the restatement and translation effects (ie the effects that arise when the foreign operation is hyperinflationary—see Agenda Paper 4A):

    (a) together in OCI; or

    (b) separately, with the restatement effect presented in equity and the translation effect presented in OCI.

15. We understand that this is because, in those two situations, the reporting entity continues to present exchange differences in OCI after the foreign operation becomes hyperinflationary. Accordingly, in those situations, there would be no basis on which to contemplate reclassifying with equity the pre-hyperinflation translation reserve.

16. The submitter therefore suggests the question arises only if the reporting entity presents the restatement and translation effects together in equity.

17. In Agenda Paper 4A, we conclude that applying IAS 21 an entity does not present the restatement and translation effects together in equity. Therefore, if the Committee were to agree with our analysis and conclusion in Agenda Paper 4A, some might suggest that the Committee does not need to consider the matter described in this paper.

18. In our view, the matter described in this paper could arise irrespective of how the entity presents the restatement and translation effects (discussed in Agenda Paper 4A). Accordingly, we think the Committee should discuss the matter in this paper regardless of its conclusion in Agenda Paper 4A.

Outreach and additional research performed

19. Paragraphs 8–11 and 15–17 in Agenda Paper 4 for this meeting describe the outreach and additional research performed. The paragraphs below summarise the results of that outreach and research with respect to the matter discussed in this paper.

Outreach

20. We asked respondents whether, in their experience, reporting entities reclassify within equity the pre-hyperinflation translation reserve when a foreign operation becomes hyperinflationary.

21. Five respondents provided information on this matter. They said entities that elect to present the restatement and translation effects together in equity generally reclassify within equity the pre-hyperinflation translation reserve—ie they apply View A as described in paragraph 15 of this paper. Two respondents said it is common for reporting entities in Spain to reclassify within equity the pre-hyperinflation translation reserve.

Additional research

22. As explained in paragraph 15 of Agenda Paper 4, we reviewed the financial statements of 36 entities to identify the accounting policy applied with respect to the pre-hyperinflation translation reserve.

23. Eight entities disclose that they reclassify within equity the pre-hyperinflation translation reserve (ie apply View A described in paragraph 15 of this paper), and seven entities disclose that they retain this reserve as a separate component of equity (ie apply View B described in paragraph 15 of this paper). The other 21 entities did not disclose their accounting policy in this respect.

24. Because many entities also do not disclose their accounting policy regarding the presentation of the restatement and translation effects for hyperinflationary foreign operations, we were unable to assess whether all entities (that present both effects in equity) reclassify within equity the pre-hyperinflation translation reserve. However, when entities did disclose (a) that they present both effects in equity and (b) their accounting policy with respect to reclassification of the pre-hyperinflation translation reserve, they reclassified within equity the pre-hyperinflation translation reserve.

Staff analysis

Applying the requirements in IAS 21

25. As explained in paragraphs 6–10 of this paper, a reporting entity that translates a non-hyperinflationary foreign operation presents any resulting exchange differences in OCI and accumulates those differences in a separate component of equity.

26. The reporting entity applies the requirements in paragraphs 42–43 of IAS 21 (see paragraph 28 of Agenda Paper 4) once the foreign operation becomes hyperinflationary.

27. Some say IAS 21 does not explicitly specify whether a reporting entity is permitted (or required) to reclassify within equity the pre-hyperinflation translation reserve when the foreign operation becomes hyperinflationary. They therefore conclude that both views described in paragraph 11 of this paper are feasible.

28. However, we note that paragraph 41 of IAS 21 includes requirements with respect to the exchange differences in question. It states (emphasis added):

> …The cumulative amount of the exchange differences is presented in a separate component of equity *until disposal of the foreign operation*…

29. Consistent with this requirement, paragraph 48 of IAS 21 states:

> On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognised in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised (see IAS 1 *Presentation of Financial Statements* (as revised in 2007)).

30. We have identified no other requirements in IAS 21 or another IFRS Standard that would permit (or require) an entity to reclassify within equity the pre-hyperinflation

translation reserve and, thus, that would override the requirements in paragraphs 41 and 48 of IAS 21.

31. Accordingly, in our view when the foreign operation becomes hyperinflationary, the reporting entity does not reclassify within equity the pre-hyperinflation translation reserve relating to that foreign operation. Instead, it retains the pre-hyperinflation translation reserve as a separate component of equity (ie it applies View B described in paragraph 11 of this paper).

Why we disagree agree with the alternative view (View A)

32. Those who support reclassifying within equity the pre-hyperinflation reserve are of the view that a reporting entity can present the restatement and translation effects together in equity (the effects that arise when the foreign operation is hyperinflationary—see Agenda Paper 4A). In their view, a reporting entity can apply that approach not only when the foreign operation is hyperinflationary but also in periods before the foreign operation becomes hyperinflationary.[1]

33. IFRIC 7 *Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies* applies in the reporting period in which an entity identifies the existence of hyperinflation. Paragraph 3 of IFRIC 7 states (emphasis added):

> In the reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, not having been hyperinflationary in the prior period, the entity shall apply the requirements of IAS 29 *as if the economy had always been hyperinflationary*…

[1] As explained in Agenda Paper 4A, we disagree with the view that an entity can present exchange differences arising on translating a hyperinflationary foreign operation directly in equity. Nonetheless, in this section we analyse whether an entity that does so can reclassify the pre-hyperinflation translation reserve within equity.

34. Paragraphs BC17 of IFRIC 7 explains this requirement and states (emphasis added):

> …The IFRIC concluded that the opening balance sheet for the reporting period in which an entity identifies the existence of hyperinflation ought to be restated as if the entity had always applied the restatement approach under IAS 29. The IFRIC reconfirmed its view that *this treatment is similar to the retrospective application of a change in accounting policy described in IAS 8* [Accounting Policies, Changes in Accounting Estimates and Errors].

35. Those who support reclassifying the pre-hyperinflation translation reserve say, if the foreign operation had always been hyperinflationary, then the reporting entity would never have applied the requirements in paragraphs 39–41 of IAS 21 when translating the foreign operation and, thus, would not have recognised any pre-hyperinflation translation reserve—instead, the reporting entity would have presented any restatement and translation effects in equity.

36. In other words, they say, applying the 'restate/translate' approach, retrospective application of the requirements in IAS 29 (the restate step) also extends to the applicable requirements in IAS 21 (the translate step)—accordingly, when the foreign operation becomes hyperinflationary, the reporting entity would reclassify within equity the pre-hyperinflation translation reserve.

37. We disagree with this view. We think the requirement in paragraph 3 of IFRIC 7—to apply the requirements in IAS 29 as if the economy had always been hyperinflationary—applies only to the requirements in IAS 29 and does not extend to requirements in IAS 21. This is because:

    (a) paragraph 3 of IFRIC 7 states (emphasis added) 'the entity shall apply the requirements in IAS 29 *as if* the currency had always been hyperinflationary…'. IAS 21 does not include any similar requirement. Paragraph 42 of IAS 21—which applies to a hyperinflationary foreign operation—applies to an entity whose (emphasis added) 'functional currency *is* the currency of a hyperinflationary economy…'. In other words, the entity applies the requirements in paragraphs 42–43 of IAS 21 only when the functional currency *is* hyperinflationary and not *as if* the currency were hyperinflationary.

(b) reclassifying the pre-hyperinflation translation reserve would negate the requirements in paragraphs 39(c) and 41 of IAS 21 to recognise a pre-hyperinflation translation reserve as a separate component of equity until disposal of the foreign operation. No requirement in IAS 21 permits an entity to negate or reverse the accounting treatment applied before the functional currency was hyperinflationary.

(c) although paragraph 3 of IFRIC 7 requires an entity to apply the requirements in IAS 29 as if the economy had always been hyperinflationary, paragraphs 42-43 of IAS 21 limit retrospective application of the IAS 29 restatement requirements by prohibiting the entity from restating comparative amounts. This confirms that retrospective application of the requirements in IAS 29 does not extend to the requirements in IAS 21.

Conclusion

38. Based on our analysis, we conclude that View B applies—ie when a foreign operation becomes hyperinflationary, the reporting entity retains the pre-hyperinflation translation reserve as a separate component of equity. This is the case irrespective of how the reporting entity presents the difference that arises on restating and translating a hyperinflationary foreign operation as discussed in Agenda Paper 4A.

Question 1 for the Committee
Does the Committee agree with our analysis of the requirements in IFRS Standards regarding the presentation of the pre-hyperinflation translation reserve, as outlined in paragraphs 28–40 of this paper and summarised in paragraph 41 of this paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[2]

39. Based on our analysis, we think the requirements in IFRS Standards provide an adequate basis for a reporting entity to determine how it presents the pre-hyperinflation translation reserve when a foreign operation becomes hyperinflationary.

Staff recommendation

40. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the Due Process Handbook (discussed in paragraph 42 above), we recommend that the Committee not add this matter to its standard-setting agenda. Instead, we recommend publishing a tentative agenda decision that outlines how an entity applies the requirements in IAS 21 and IAS 29 to the fact pattern described in the submission.

41. Appendix A to this paper sets out the proposed wording of the tentative agenda decision.

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

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

Appendix A—Proposed wording of the tentative agenda decision

Cumulative Exchange Differences arising before a Foreign Operation becomes Hyperinflationary (IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IAS 29 *Financial Reporting in Hyperinflationary Economies*)

The Committee received a request about the application of IAS 21 and IAS 29. In the fact pattern described in the request, the entity:

(a) has a presentation currency that is not the currency of a hyperinflationary economy as defined in IAS 29;

(b) has a foreign operation with a functional currency that is the currency of a hyperinflationary economy as defined in IAS 29 (hyperinflationary foreign operation); and

(c) in preparing its consolidated financial statements, translates the results and financial position of the hyperinflationary foreign operation into its presentation currency.

Before the foreign operation becomes hyperinflationary, IAS 21 requires an entity to (a) present in other comprehensive income (OCI) any exchanges differences resulting from translating the results and financial position of that non-hyperinflationary foreign operation; and (b) present in a separate component of equity the cumulative amount of those exchange differences (pre-hyperinflation foreign currency translation reserve (FCTR)).

The request asked whether, at the beginning of the period during which the foreign operation becomes hyperinflationary, the entity reclassifies within equity the pre-hyperinflation FCTR––that is, whether the entity transfers the pre-hyperinflation FCTR to a component of equity that is not subsequently reclassified to profit or loss.

The Committee observed that paragraph 41 of IAS 21 requires the entity to present the pre-hyperinflation FCTR in a separate component of equity 'until disposal of the foreign operation'. Furthermore, paragraph 48 of IAS 21 requires the entity to reclassify the pre-hyperinflation FCTR from equity to profit or loss (as a reclassification adjustment) on disposal of the foreign operation.

Accordingly, the Committee concluded that, in the fact pattern described in the request, the entity retains the pre-hyperinflation FCTR as a separate component of equity (to which paragraph 48 of IAS 21 applies) until disposal of the foreign operation. The entity does not reclassify within equity the pre-hyperinflation FCTR when the foreign operation becomes hyperinflationary.

The Committee concluded that the requirements in IAS 21 provide an adequate basis for an entity to determine how to present the pre-hyperinflation FCTR when a foreign operation becomes hyperinflationary. Consequently, the Committee [decided] not to add the matter to its standard-setting agenda.