IFRS Accounting

Staff paper

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Project	**Lack of Exchangeability (Proposed amendments to IAS 21)**
Topic	**Determining the spot exchange rate when exchangeability is lacking**
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Purpose of this paper

1. As discussed in Agenda Paper 12 for this meeting, this paper provides our analysis of the main comments received on Question 2—determining the spot exchange rate when exchangeability is lacking—in the Exposure Draft *Lack of Exchangeability* and our recommendations for the International Accounting Standards Board (IASB).

2. Our analysis and recommendations take into account feedback in comment letters, as well as feedback from members of the Emerging Economies Group (EEG) at their May 2022 meeting and feedback from members of the IFRS Interpretations Committee at their September 2022 meeting (September 2022 Agenda Paper 5).

Structure of this paper

3. This paper includes:

   (a) summary of staff recommendations;

   (b) background;

   (c) staff analysis and recommendations related to:

      (i) estimated rates meeting the objective in paragraph 19A;

      (ii) observable exchange rates in paragraph 19B;

      (iii) reference rates, examples and application guidance; and

   (d) question for the IASB (after paragraph 24).

4. The Appendix to this paper sets out preliminary examples to illustrate how an entity might apply our recommended changes to the proposed requirements in estimating the spot exchange rate.

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Summary of staff recommendations

5. We recommend that the IASB:

    (a) amend proposed paragraph 19A to state that an entity's objective in estimating the spot exchange rate is to reflect at the measurement date the rate at which an orderly exchange transaction would take place between market participants under prevailing economic conditions;

    (b) continue to permit, but not require, the use of observable exchange rates; and

    (c) make no change to specify detailed estimation requirements or the use of particular estimation techniques or reference rates for an entity to estimate the spot exchange rate.

Background

Proposals in the Exposure Draft

6. The Exposure Draft proposed that when exchangeability between two currencies is lacking (when a currency is not exchangeable into another currency at a measurement date), an entity would estimate the spot exchange rate at that date. The Exposure Draft proposed to add paragraphs 19A–19C and A12–A15 to IAS 21 to provide requirements applicable to an entity estimating the spot exchange rate. Those proposals are discussed below.

Respondents' comments

7. Most respondents to the Exposure Draft agreed with the proposal to require an entity to estimate the spot exchange rate when exchangeability between two currencies is lacking. Some respondents agreed fully with the proposed requirements on how to estimate the spot exchange rate; most asked for further clarification or suggested changes. Some respondents disagreed with or expressed concerns about an entity estimating the spot exchange rate when there is a lack of reliable market data.

Staff analysis and recommendations

Estimated rates meeting the objective in paragraph 19A

Proposals in the Exposure Draft

8. Proposed paragraph 19A of the Exposure Draft states:

    > When exchangeability between two currencies is lacking—that is, when a currency is not exchangeable into another currency (as described in paragraphs A2–A11) at a measurement date—an entity shall estimate the spot exchange rate at that date. The

estimated spot exchange rate shall meet the following conditions assessed at the measurement date:

(a) a rate at which an entity would have been able to enter into an exchange transaction had the currency been exchangeable into the other currency;

(b) a rate that would have applied to an orderly transaction between market participants; and

(c) a rate that faithfully reflects the prevailing economic conditions.

Respondents' comments

9. Respondents' comments on this aspect of the proposals included the following:

    (a) a few respondents said, when exchangeability is lacking, meeting the conditions in proposed paragraph 19A may be impracticable;

    (b) one respondent questioned whether exchangeability would actually be lacking if the conditions were met; and

    (c) some respondents suggested revising the proposal to specify that the conditions are objectives an entity aims to meet when estimating the spot exchange rate, rather than requirements to be met.

Staff analysis and recommendations

10. After considering respondents' feedback, we think proposed paragraph 19A fails to convey with sufficient clarity how the IASB intended an entity to apply the proposed requirements. In applying proposed paragraph 19A, an entity would need to estimate the spot exchange rate in such a way that the conditions would be met—even though the entity may be unable to enter into a market transaction to exchange one currency for another at the estimated rate on the measurement date. In other words, in a situation in which exchangeability is lacking, an entity applying paragraph 19A could be required to meet conditions that do not necessarily exist in the market.

11. We acknowledge respondents' comments that it may be difficult to determine an estimated spot exchange rate that meets all conditions in proposed paragraph 19A. In our view, the word 'conditions' might imply that the three criteria or factors could be met or could exist at the measurement date in all circumstances, whereas the intended objective is for an entity to estimate a rate at which an exchange transaction *hypothetically* would take place at that date. While not the same, we think this is similar to measuring an asset or liability at fair value when an entity estimates the price at which an orderly transaction to sell the asset or transfer the liability *hypothetically* would take place at the measurement date.

12. Considering feedback on the Exposure Draft and from our discussions with members of the EEG and the IFRS Interpretations Committee, we recommend that the IASB amend paragraph 19A to state that

an entity's objective in estimating the spot exchange rate is to reflect at the measurement date the rate at which an orderly exchange transaction would take place between market participants under prevailing economic conditions. We think this approach is consistent with the IASB's intent in developing the proposals while being responsive to feedback. We also note that the structure, and some of the wording, of this proposed objective is similar to that of the objective set out in paragraph 2 of IFRS 13 *Fair Value Measurement* when measuring an asset or liability at fair value.

Observable exchange rates in paragraph 19B

Proposals in the Exposure Draft

13. Proposed paragraph 19B and paragraph BC19 of the Basis for Conclusions on the Exposure Draft state:

> 19B. In estimating the spot exchange rate as required by paragraph 19A, an entity may use an observable exchange rate as the estimated spot exchange rate when that observable exchange rate meets the conditions in paragraph 19A and is either:
>
> (a) a spot exchange rate for a purpose other than that for which the entity assesses exchangeability; or
>
> (b) the first exchange rate at which an entity is able to obtain the other currency after exchangeability of the currency is restored (first subsequent exchange rate).
>
> BC19. The Board noted that when a currency is not exchangeable into another currency, an entity would not necessarily need to use a complex estimation technique. In some situations an entity could estimate the spot exchange rate by starting with an observable exchange rate and adjusting that rate, as necessary, to estimate the spot exchange rate as proposed in paragraph 19A. To reduce complexity, the Board also decided to explicitly permit an entity to use an observable exchange rate as the estimated spot exchange rate in two situations if that observable exchange rate would meet the conditions in proposed paragraph 19A…

Respondents' comments

14. Respondents' comments on this aspect of the proposals include the following:

    (a) some said the wording in proposed paragraph 19B is unclear; and

    (b) some—including members of the EEG and IFRS Interpretations Committee—commented on the proposal to permit, but not require, an entity to use an observable exchange rate as the estimated spot exchange rate. These respondents suggested:

        (i) requiring an entity to use observable exchange rates, including a rebuttable presumption to this effect, or requiring the disclosure of reasons for not using an observable exchange rate;

(ii) maximising the use of observable exchange rates, similar to the fair value hierarchy in IFRS 13; or

(iii) specifying a required sequencing of using observable exchange rates—respondents had differing views on what the sequence should be.

Staff analysis and recommendations

15. We acknowledge feedback that requiring an entity to use—or maximise the use of—observable exchange rates, or specifying a required sequencing of using observable exchange rates, might increase comparability across entities affected by a lack of exchangeability. However, we recommend that the IASB continue to permit, but not require, the use of observable exchange rates and further explain the reasons in the Basis for Conclusions. Those reasons include:

    (a) the proposed requirement in paragraph 19B to explicitly permit an entity to use either of the observable exchange rates specified in paragraph 19B (if paragraph 19A is also met) is intended to reduce complexity for entities in estimating the spot exchange rate—as explained in paragraph BC19 of the Basis for Conclusions on the Exposure Draft; and

    (b) mandating a hierarchy of exchange rates may impose costs without providing more useful information for investors. Estimation of the spot exchange rate is entity-specific. Mandating a hierarchy of exchange rates would require an entity to look for and successively consider each exchange rate in the hierarchy, when it may be more cost effective for the entity to use another estimation technique that would result in a rate that complies with the objective.

16. We also recommend clarifying in drafting that, when estimating the spot exchange rate, the focus is always on calculating a rate that meets the objective (as described in paragraph 12). An entity can start with any observable rate—not only the two observable rates specified in proposed paragraph 19B—and adjust that rate, as necessary, to estimate a rate that meets the objective. What matters is estimating a rate that meets the objective.

Reference rates, examples and application guidance

Proposals in the Exposure Draft

17. Paragraph BC18 of the Basis for Conclusions on the Exposure Draft states:

> …The Board did not propose any detailed requirements on how an entity should [estimate the spot exchange rate] because:
>
> (a) estimating a spot exchange rate can be complicated and would depend on entity-specific and jurisdiction-specific facts and circumstances.
>
> (b) there are many economic models an entity might use to estimate a spot exchange rate… Prescribing one estimation technique or approach would be inappropriate

because it would be unlikely to capture all relevant factors for all possible situations in a way that would not be too burdensome.

(c) the requirements for assessing exchangeability are expected to result in an entity estimating the spot exchange rate only in a narrow set of circumstances.

(d) the uncertainties inherent in estimating a spot exchange rate are similar to those that relate to other financial information based on estimates. Disclosing relevant information about the estimated spot exchange rate and the estimation technique would supplement the proposed approach…

(e) such an approach is consistent with the measurement requirements in other IFRS Standards…

Respondents' comments

18. Some respondents suggested permitting the use of particular inputs, mechanisms or reference rates in estimating the spot exchange rate—for example, purchase parity indices, implied rates and methods based on bonds traded on foreign markets.

19. Some respondents, including some EEG members, requested examples and application guidance on aspects of the proposals, including to support application of proposed paragraphs 19A and 19B and on techniques and inputs to use in estimating the spot exchange rate.

Staff analysis and recommendations

20. After considering the feedback, in our view the IASB's approach—not to provide detailed estimation requirements or describe particular estimation techniques—and its reasoning set out in paragraph BC18 remain valid. Estimating the spot exchange rate can be complicated and would depend on entity-specific and jurisdiction-specific facts and circumstances; prescribing one estimation technique or approach would be unlikely to capture all relevant factors for all possible situations.

21. We think our combined package of requirements and examples for the estimation of the spot exchange rate would clarify the requirements. This package would include: our recommendations as summarised in paragraph 5 of this paper; our recommendation in Agenda Paper 12A to clarify that rates from exchange transactions that do not create enforceable rights and obligations can be used as a starting point for estimating the spot exchange rate when exchangeability is lacking; and illustrative examples (see paragraphs 23–24 below and the Appendix to this paper).

22. We therefore recommend that the IASB make no change to provide or describe detailed estimation requirements or particular estimation techniques or reference rates for an entity to estimate the spot exchange rate.

23. We will consider in drafting how to revise Illustrative Example 4 in the Exposure Draft and provide additional examples to illustrate how an entity might:

    (a) apply the requirements in paragraph 19A—the entity's objective in estimating the spot exchange rate;

    (b) apply the requirements in paragraph 19B—there is no hierarchy of exchange rates to use. Depending on the specific facts and circumstances, an entity considers whether to use an observable exchange rate (as permitted by paragraph 19B) or another estimation technique to meet the objective in paragraph 19A; and

    (c) use rates from exchange transactions that do not create enforceable rights and obligations as a starting point for estimating the spot exchange rate.

24. We include in the Appendix to this paper a reproduction—from Appendix B of Agenda Paper 5 for the September 2022 IFRS Interpretations Committee meeting—of our preliminary examples to illustrate how an entity might apply our recommended changes to the proposed requirements in estimating the spot exchange rate.

Question for the IASB

Does the IASB agree with our recommendations set out in paragraph 5 to:

(a) amend proposed paragraph 19A to state that an entity's objective in estimating the spot exchange rate is to reflect at the measurement date the rate at which an orderly exchange transaction would take place between market participants under prevailing economic conditions;

(b) continue to permit, but not require, the use of observable exchange rates; and

(c) make no change to specify detailed estimation requirements or the use of particular estimation techniques or reference rates for an entity to estimate the spot exchange rate.

Appendix—Examples to illustrate how an entity might apply our recommended changes to the proposed requirements in estimating the spot exchange rate

A1. We are considering revising Illustrative Example 4 and adding examples to illustrate how an entity might apply our recommended changes to the proposed requirements in estimating the spot exchange rate. The examples are preliminary and may change in the process of drafting the amendments.

A2. The examples are not intended to provide interpretative guidance; rather, they illustrate how an entity might apply some of the requirements in hypothetical situations based on the limited facts presented. Although some aspects of the examples may be present in actual fact patterns, fact patterns in those examples are simplified, and an entity would need to evaluate all relevant facts and circumstances when applying the requirements.

A3. In each of the following fact patterns, Entity X has a functional and presentation currency of PC and prepares consolidated financial statements. Entity X has a subsidiary, Entity Y, that is a foreign operation. Entity Y's functional currency is LC, the currency of the jurisdiction in which Entity Y operates. The relevant jurisdictional authority administers the exchangeability of LC for other currencies. Entity X is required to determine the spot exchange rate between LC and PC for the purpose of translating Entity Y's results and financial position for inclusion in its consolidated financial statements.

Step II: Determining the spot exchange rate when exchangeability is lacking (paragraphs 19A–19B and A12–A15)

IE9 When exchangeability between two currencies is lacking, an entity estimates the spot exchange rate at that date. The entity's objective in estimating the spot exchange rate is to reflect at the measurement date the rate at which an orderly exchange transaction would take place between market participants under prevailing economic conditions. In estimating the spot exchange rate, depending on the specific facts and circumstances, an entity considers whether to use an observable exchange rate (as permitted by paragraph 19B) or another estimation technique. An entity considers other estimation techniques that are appropriate in the circumstances and for which sufficient data is available to estimate the spot exchange rate.

Example 4—Using an observable exchange rate for another purpose (paragraph 19B(a))

Fact pattern

IE10 At 31 December 20X1, the jurisdictional authority in Entity Y's jurisdiction prevents entities from obtaining PC for a purpose that would result in the realisation of a net investment in an entity operating in that jurisdiction. Other than that restriction, entities are able to obtain PC and the LC:PC exchange rate is free-floating. Only one exchange rate applies to transactions for exchanges of LC for PC; it is updated several times a day.

Assessing exchangeability between LC and PC

IE11 At the measurement date of 31 December 20X1, because Entity X is unable to obtain PC to realise its net investment in Entity Y, Entity X concludes that LC is not exchangeable into PC.

Estimating the spot exchange rate

IE12 Because Entity X concludes that LC is not exchangeable into PC, Entity X is required to estimate the spot exchange rate that reflects at the measurement date the rate at which an orderly exchange transaction would take place between market participants under prevailing economic conditions (paragraph 19A).

IE13 Entity X considers whether it might use the observable LC:PC exchange rate that is used for purposes other than the realisation of a net investment in an entity. To do so, it assesses whether that observable exchange rate meets the objective in paragraph 19A for the purpose of realising its net investment in Entity Y. In doing so, Entity X applies paragraph A13 and considers:

(a) *whether several exchange rates exist*—only one observable exchange rate exists between LC and PC.

(b) *the purpose for which the currency is exchangeable*—Entity X is able to obtain PC for any transaction other than a transaction that would result in the realisation of its net investment in Entity Y.

(c) *the nature of the exchange rate*—the observable exchange rate is free-floating.

(d) *the frequency with which exchange rates are updated*—the observable exchange rate is updated several times a day.

IE14 Considering these factors, Entity X determines that, in estimating the spot exchange rate for the purpose of realising its net investment in Entity Y, the observable LC:PC exchange rate meets the objective in paragraph 19A. Therefore, Entity X may use that observable exchange rate as the estimated spot exchange rate when it translates the results and financial position of Entity Y.

Example 5—Using the first subsequent exchange rate (paragraph 19B(b))

Fact pattern

IE15 At 31 December 20X1, the jurisdiction in which Entity Y operates is subject to hyperinflation and the jurisdictional authority in Entity Y's jurisdiction prevents entities from obtaining PC for a purpose that would result in the realisation of a net investment in an entity operating in that jurisdiction. Four months later, at 30 April 20X2, that jurisdictional authority then allows entities to obtain PC for a purpose that would result in the realisation of a net investment in an entity operating in that jurisdiction.

Assessing exchangeability between LC and PC

IE16 At the measurement date of 31 December 20X1, because Entity X is unable to obtain PC to realise its net investment in Entity Y, Entity X concludes that LC is not exchangeable into PC.

Estimating the spot exchange rate

IE17 Because Entity X concludes that LC is not exchangeable into PC, Entity X is required to estimate the spot exchange rate that reflects at the measurement date the rate at which an orderly exchange transaction would take place between market participants under prevailing economic conditions (paragraph 19A).

IE18 Entity X considers whether it might use the first exchange rate at which an entity is able to obtain the other currency after exchangeability of the currency is restored (first subsequent exchange rate). To do so, it assesses whether that first subsequent exchange rate meets the objective in paragraph 19A for the purpose of realising its net investment in Entity Y. In doing so, Entity X applies paragraph A15 and considers:

(a) *the time between the measurement date and the date at which exchangeability is restored*—the measurement date is 31 December 20X1 and exchangeability is restored four months later at 30 April 20X2.

(b) *inflation rate*—the jurisdiction in which Entity Y operates is subject to hyperinflation.

IE19 Considering these factors, Entity X determines that the first subsequent exchange rate does not reflect the prevailing economic conditions at the measurement date and, therefore, does not meet the objective in paragraph 19A for the purpose of realising Entity X's net investment in Entity Y.

Other estimation technique

IE20 In estimating the spot exchange rate, Entity X considers whether it might use the first subsequent exchange rate described in paragraphs IE18–IE19 as a starting point (which it would then adjust) by taking into account the following information:

(a) exchangeability is restored four months after the measurement date—Entity X considers that the time period that elapses before exchangeability is restored is not short.

(b) the jurisdiction in which Entity Y operates is subject to hyperinflation—Entity X considers that the first subsequent exchange rate does not reflect the prevailing economic conditions at the measurement date and assesses that changes in inflation rates are the main determinant of exchange rate movements. Information about inflation rates in the jurisdictions in which Entity X and Entity Y operate is publicly available.

IE21 Considering these factors, Entity X adjusts the first subsequent exchange rate accordingly and determines that the adjusted rate meets the objective in paragraph 19A for the purpose of realising Entity X's net investment in Entity Y. Therefore, Entity X may use that adjusted rate as the estimated spot exchange rate when it translates the results and financial position of Entity Y.

Example 6—Using rates from exchange transactions that do not create enforceable rights and obligations

Fact pattern

IE22 At 31 December 20X1, the jurisdictional authority in Entity Y's jurisdiction prevents entities from obtaining PC for a purpose that would result in the realisation of a net investment in an entity operating in that jurisdiction. However, individual resellers settle transactions to exchange LC for PC at an exchange rate not set by the jurisdictional authority and such exchange transactions do not create enforceable rights and obligations.

Assessing exchangeability between LC and PC

IE23 In assessing whether LC is exchangeable into PC, Entity X considers only markets or exchange mechanisms in which a transaction to exchange LC for PC would create enforceable rights and obligations. At the measurement date of 31 December 20X1, because Entity X is unable to obtain PC to realise its net investment in Entity Y, Entity X concludes that LC is not exchangeable into PC.

Estimating the spot exchange rate

IE24 Because Entity X concludes that LC is not exchangeable into PC, Entity X is required to estimate the spot exchange rate that reflects at the measurement date the rate at which an orderly exchange transaction would take place between market participants under prevailing economic conditions (paragraph 19A).

Other estimation technique

IE25 Entity X considers whether it might use an estimation technique using rates from exchange transactions that do not create enforceable rights and obligations to determine the spot exchange rate. While such transactions are not considered in assessing whether LC is exchangeable into PC, Entity X can consider whether to use the exchange rate from such transactions as a starting point to estimate the spot exchange rate.

IE26 Entity X determines that, for the purpose of realising its net investment in Entity Y, it can use the exchange rate from such transactions as a starting point and adjust it as needed to meet the objective in paragraph 19A. Therefore, Entity X may use that rate as the estimated spot exchange rate when it translates the results and financial position of Entity Y.