STAFF PAPER

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IASB Meeting

Project	**Foreign Currency Translation**		
Paper topic	Long-term monetary items		
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Introduction

1. In December 2011, the IASB received a request from the Korea Accounting Standards Board (KASB) to add a project to the IASB's agenda for a narrow-scope amendment to IAS 21*The Effects of Changes in Foreign Exchange Rates.* The proposal relates to the translation of long-term monetary items denominated in a foreign currency into an entity's functional currency. The full proposal is given in Appendix A of Agenda Paper 8A(d). This is the issue that was added to the Research Programme in May 2012.

2. In this paper, we:

   (a) summarise the KASB's assessment of the financial reporting issue and its proposal;

   (b) review the outreach carried out to date;

   (c) make an initial assessment of the issue and the KASB's proposal and ask the IASB whether it agrees with the staff recommendation not to proceed any further on this issue.

Proposal for a narrow-scope amendment

Background

3. When reporting foreign currency transactions in an entity's functional currency, paragraph 23 of IAS 21 requires all foreign currency monetary items to be translated using the closing rate at the end of each reporting period.[1] The closing rate is the spot exchange rate, which is the exchange rate for immediate delivery, at the end of the reporting period.

4. The KASB asserts that the requirement in paragraph 23 of IAS 21 is the source of a recurring request from entities in emerging economies. Those entities request that a different exchange rate is used for translating long-term contracts in times of financial crises when foreign exchange rates become unusually volatile. Those requests reflect a view that such foreign exchange volatility distorts profit and debt-to-equity ratios, particularly in respect of long-term items. They believe that recognising significant exchange rate fluctuations on long term monetary items in such circumstances does not faithfully represent the amount that those balances will eventually be settled at in the functional currency. They provide examples in which exchange rates that have significantly fluctuated during a financial crisis have become less volatile after a period of time.

Proposal

5. The KASB proposes that the following changes to IAS 21 should be made in respect of reporting foreign currency transactions in the functional currency:

   (a) alternative rates to the closing rate should be required or permitted for translating long-term foreign currency monetary assets and liabilities in the *rare circumstances when the closing rate does not reflect the market's best estimate of future events that affect currency*. [emphasis added]

   (b) the KASB would define rare circumstances as being when both the following apply :

[1] Monetary items are defined as units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

(i) the foreign exchange market is classified as a 'thin market'; and

(ii) there is significant exchange rate fluctuation due to exceptional and temporary shocks, such as financial crises.

(c) alternative rates could be based on an:

(i) adjusted historical rate model; that is, the exchange rate is determined using a long-term trend line obtained from historical data (for example moving average rate); or

(ii) expected rate model; that is, the exchange rate that represents the normal rate over the long-term, reflecting the best estimate of future events.

Rationale for the proposal

6. The KASB observes that IAS 21 does not contain a Basis for Conclusions or any rationale for its accounting requirements, including the use of the spot rate to translate monetary items at the reporting date.

7. The KASB asserts that using the spot rate at the reporting date cannot, by itself, be a principle.

8. The KASB's view is that the appropriate principle is to translate foreign currency monetary transactions using a rate that reflects the best estimate of the future rate at the time of receipt or settlement of foreign currency monetary items. In most cases the spot rate reflects the best estimate of future events. This approach is consistent with the use of the spot rate in IAS 36 *Impairment of Assets* for value in use calculations because it reflects the market's best estimate of future events that will affect that currency (see paragraphs 54 and BCZ47 of IAS 36 given in Appendix A).

9. However the KASB notes that paragraph BCZ50 of IAS 36 states that if a currency is not freely convertible or is not traded in an active market, 'it can no longer be assumed that the spot rate reflects the market's best estimate of future events that will affect that currency'.

10. On this basis, the KASB concluded that there could be circumstances in which the spot rate does not represent the best estimate of future events that will affect a foreign

currency for translating long-term monetary items. The paper asserts that for entities operating in emerging economies this occurs during financial crises when the foreign exchange market is a thin market. Thin markets are markets dominated by a small number of market operators instead of many individual participants or in which a small amount of change in supply and demand significantly affects transaction prices. This assertion is based on a review of academic papers that indicates that:

(a) spot rates in a thin market do not reflect the market's best estimate of future economic benefit of an entity's cash flows; and

(b) volatility in the exchange rates of many emerging economies during the financial crises is attributed to the thinness of the market.

11. The KASB acknowledges that further discussion and research is needed, and has identified the following needs:

(a) an in-depth study on microstructure of foreign currency markets using research in the field of economics (which could be outsourced);

(b) development of concrete indicators to determine a thin market;

(c) determination of the characteristics of an 'alternative rate'; and

(d) that it would be helpful and more efficient to develop the amendment alongside a wider review of the objectives of IAS 21. (This is discussed further in Agenda Paper 8A(b).)

12. The KASB also acknowledges that some hold an alternative view, which is that using the spot rate to translate monetary items in such circumstances does faithfully represent the economic substance of the effect of a rate change. Hence there is no need for the proposed amendment. Those of this view argue that the volatility of exchange rates is a matter of foreign exchange market operation rather than an issue with the accounting requirement.

Outreach

13. Limited outreach has been performed to date. If the IASB decides to consider this issue further, then we would conduct more outreach. However, it was an issue identified by the IASB in the 2011 Agenda Consultation Request for Views.

14. Furthermore, the FX Research Team at the KASB presented their proposal to the Asian-Oceanian Standard-Setters Group (AOSSG) in November 2011 and to the Emerging Economies Group (EEG) in December 2011.

AOSSG meeting November 2011

15. The AOSSG's meeting in November 2011 was attended by representatives from 21 national standard-setters as well as representatives of the IASB and the IFRS Foundation. The Communique of the AOSSG's meeting in November 2011 notes that 'a number of members encouraged the KASB to further develop the proposal for a limited scope amendment to IAS 21 to address rare circumstances where the closing spot rate does not represent a best estimate'. They also encouraged the KASB to raise the issue to the IASB for consideration.

EEG meeting December 2011

16. The KASB proposal was also discussed at the meeting of the EEG in December 2011. Representatives from national standard-setters from Korea, India, China, Brazil, South Africa, Russia and Malaysia were present at the meeting.

17. A few members of the group voiced similar concerns that, compared to short-term items, long-term monetary items were not as sensitive to short term volatilities in exchange rates, which was not reflected in IAS 21. However, other representatives were concerned that a rate other than the closing rate would not portray the position at reporting date.

18. The EEG briefly discussed alternative accounting treatments, which highlights the diversity of thoughts on the issue:

    (a) the KASB paper argued for an alternative rate to the closing spot rate based on an economic model. Some thought using forward rates might be more appropriate than closing rates (if you can exclude interest component), but others opposed this or thought that it was not practical.

(b) one suggestion was to recognise foreign exchange gains and losses in other comprehensive income (OCI) instead of profit or loss, but others thought that the IASB should first establish a principle for OCI as part of the *Conceptual Framework*.

(c) a third alternative treatment suggested was to defer and amortise foreign exchange differences, particularly for long-term items.

2011 Agenda Consultation

19. Foreign currency translation was raised as a topic for a possible IASB research project in the 2011 Agenda Consultation Request for Views. Forty-three (out of 246) respondents to the Request for Views commented on the proposed Foreign Currency Translation Research Project.

20. About half of the respondents who commented on this topic believed that it is of high to medium priority, a significant number of which came from Asia. The other half considered it to be a low priority, on the basis that IAS 21 is performing adequately.

21. A few respondents who favoured adding this project to the agenda thought a comprehensive project was necessary, but most felt that a narrow-scope improvement, possibly through a Post-implementation Review of IAS 21, would be sufficient. A range of topics for such a narrow-scope improvement was raised by these respondents (for example, recycling cumulative translation adjustments, determining functional currency, interaction with hedging and inflation requirements), in addition to this issue raised by the KASB, but there was no common area of concern.

Staff initial assessment

22. As noted previously, IAS 21 does not contain any rationale for its requirements and therefore it is helpful to have a reminder of the qualitative characteristics in the *Conceptual Framework*. Paragraphs QC4-QC18 of the *Conceptual Framework* state that the fundamental qualitative characteristics of useful financial information are:

(a) relevance: that is, the information has predictive and/or confirmatory value; and

(b) faithful representation: the information should be complete, useful and free from error.

23. The *Conceptual Framework* also sets out the enhancing qualitative characteristics as comparability; verifiability; timeliness and understandability (see paragraphs QC19-QC34 of the *Conceptual Framework*).

24. In addition, the *Conceptual Framework* reminds us that there is a cost restraint on useful financial reporting and that an assessment should be made on whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information.

Use of the spot rate

25. The current requirements of IAS 21 are clear: IAS 21 requires all long-term monetary items to be translated at the reporting date using the spot exchange rate at that date. Although the exchange rate will change before a long-term monetary item is settled, the spot rate at the reporting date is relevant, because it gives the best indication of the future cash flows expected on foreign currency monetary items that is free from error, comparable, verifiable and understandable.

26. Furthermore, the spot rate represents the economic conditions at the reporting date and therefore most faithfully represents the conditions at the reporting date.

Limited exception to the spot rate

27. The KASB's proposal notes that proponents of introducing an exception to the spot rate agree that in general using the spot rate to translate long-term monetary items at the reporting date provides the best estimate of future cash flows in the functional currency. However, they argue that in the rare circumstances that they specify, spot rates do not represent the most predictive value for long-term monetary items, because studies have shown that volatility in exchange rates reduces after an economic crisis.

28. They also argue that the use of the closing rate does not faithfully represent the economics of long-term items in such circumstances. Instead, it introduces volatility into the income statement that will not be realised. They argue that it should be possible to estimate an exchange rate that more faithfully represents the effect of foreign exchange rates over time on long-term items, which they believe will enhance the understandability of the impact of changes in exchange rates on those items.

29. On the other hand, those that support the use of the spot rate in such circumstances observe that there is a foreign exchange market during times of financial crises, even if it is sometimes thin, and that this market reflects the uncertainty of the current economic conditions at the reporting date.

30. In addition, they highlight the practical difficulties of introducing an exception to the spot rate, both in terms of determining an appropriate alternative rate to use and the precise circumstances in which an alternative rate might be permissible. They note that IAS 36 does not permit an exception to the use of the spot rate in determining value in use. Paragraph BCZ50 of IAS 36 states that 'even if a currency is not freely convertible or is not traded in an active market, the spot rate is still used because the IASC believed that it was unlikely that an entity can make a more reliable estimate of future exchange rates than the current spot exchange rate'.

31. We agree with this contra view and support the use of the spot rate in these circumstances as the best estimate of future exchange rates. A thinly traded currency will have higher bid-ask spreads and will be more susceptible to price movements caused by single trades than a deeply-traded currency. However, although IAS 21 does not contain a Basis for Conclusions, the requirements in the Standard make it clear that the spot rate is used because it is the rate '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'.[2]

32. We also think that the Basis for Conclusions on IAS 36 provides supportive comments on the use of a spot rate as being the best estimate of future exchange rates. Although it is possible that thinly traded currencies exhibit bigger movements

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[2] See paragraph 26 of IAS 21.

between a spot rate and future rates than deeply traded currencies, the spot rate remains the best estimate of those future rates.

Cost: benefit considerations

33. The proposed exception is expected to apply in rare circumstances and therefore would be inherently of limited benefit (although when it does affect entities, it could have significant impact and implications). However, developing such an exception would involve significant costs because more outreach and research would be needed to determine the extent of the issue and scope of exception to IAS 21 (possibly developing objectives of IAS 21), as well as the difficulties that would be encountered in determining a reliable and predictive alternative exchange rate in practice.

34. Furthermore, the proposed limited exception would make the Standard more complex and difficult to apply in determining when the exception applies and calculating an alternative rate that is verifiable, given that a spot rate is available.

Staff recommendation

35. The staff recommend that the IASB not take this specific issue further forward as a limited amendment project in its own right, for the following reasons:

    (a) the arguments for maintaining the use of the spot rate in the circumstances described are convincing: economic markets give best predictive value that more faithfully represents economic condition at the reporting date, even for long-term monetary items in times of thin markets and financial crises.

    (b) it is unlikely that the benefits of such a proposal would justify the costs of developing (or possibly applying) such an exception.

    (c) there is limited support for such an exception from the outreach available, given, for example, the mixed views from the EEG discussion and the responses to the Agenda Consultation.

Question for IASB
Does the IASB agree with the staff recommendation not to pursue a narrow-scope amendment to IAS 21 to introduce a limited exception to the use of the closing rate for long-term monetary items, for the reasons outlined in paragraph 35?

APPENDIX A

Extracts from IAS 36 *Impairment of Assets*

Foreign currency future cash flows

54 Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An entity translates the present value using the spot exchange rate at the date of the value in use calculation.[3]

Value in use estimated in a foreign currency (paragraph 54)

BCZ46 In response to comments from field test participants, paragraph 54 of IAS 36 includes guidance on calculating the value in use of an asset that generates future cash flows in a foreign currency. IAS 36 indicates that value in use in a foreign currency is translated into the reporting currency[4] using the spot exchange rate at the balance sheet date.

BCZ47 If a currency is freely convertible and traded in an active market, the spot rate reflects the market's best estimate of future events that will affect that currency. Therefore, the only available unbiased estimate of a future exchange rate is the current spot rate, adjusted by the difference in expected future rates of general inflation in the two countries to which the currencies belong.

BCZ48 A value in use calculation already deals with the effect of general inflation since it is calculated either by:

(a) estimating future cash flows in nominal terms (ie including the effect of general inflation and specific price changes) and discounting them at a rate that includes the effects of general inflation; or

(b) estimating future cash flows in real terms (ie excluding the effect of general inflation but including the effect of specific price changes) and discounting them at a rate that excludes the effect of general inflation.

BCZ49 To use a forward rate to translate value in use expressed in a foreign currency would be inappropriate. This is because a forward rate reflects the market's adjustment for the differential in interest rates. Using such a rate would result in double-counting the time value of money (first in the discount rate and then in the forward rate).

BCZ50 Even if a currency is not freely convertible or is not traded in an active market—with the consequence that it can no longer be assumed that the spot exchange rate reflects the market's best estimate of future events that will affect that currency—IAS 36 indicates that an enterprise uses the spot exchange rate at the balance sheet date to translate value in use estimated in a foreign currency. This is because IASC believed that it is unlikely that an enterprise can make a more reliable estimate of future exchange rates than the current spot exchange rate.

BCZ51 An alternative to estimating the future cash flows in the currency in which they are generated would be to estimate them in another currency as a proxy and discount them at a rate appropriate for this other currency. This solution may be simpler, particularly where cash flows are generated in the currency of a hyperinflationary economy (in such cases, some would prefer using a hard currency as a proxy) or in a currency other than the reporting currency. However, this solution may be misleading if the exchange rate varies for reasons other than changes in the differential between the general inflation rates in the two countries to which the currencies belong. In addition, this solution is inconsistent with the approach under IAS 29 *Financial Reporting in Hyperinflationary Economies*, which does not allow, if the reporting currency[4] is the currency of a hyperinflationary economy, translation into a hard currency as a proxy for restatement in terms of the measuring unit current at the balance sheet date.[5]

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[3] Extracted from IAS 36 *Impairment of Assets*.

[4] In IAS 21 *The Effects of Changes in Foreign Exchange Rates*, as revised by the IASB in 2003, the term 'reporting currency' was replaced by 'functional currency'.

[5] Extracted from the Basis for Conclusions on IAS 36.