STAFF PAPER

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IASB Meeting

Project	**IFRS Interpretations Committee issues**
Paper topic	IAS 21—Foreign exchange restrictions and hyperinflation

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Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a submission requesting guidance on the translation and consolidation of the results and financial position of foreign operations in Venezuela when applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The issue arises because of strict foreign exchange controls over the exchange of the Venezuelan Bolivar Fuerte (VEF) combined with Venezuela's hyperinflationary economy.

2. The Interpretations Committee discussed the issue at its meeting in July 2014[1]. It tentatively decided not to take the issue onto its agenda, as noted in the IFRIC Update reproduced in Appendix A. In addition, after acknowledging the concerns raised by the submitter, the Interpretations Committee specifically asked that the IASB be made aware of the issue.

3. Accordingly, this paper summarises the issue and tentative conclusions reached by the Interpretations Committee, as follows:

   (a) Background, which summarises the foreign exchange restrictions in Venezuela, the submission and primary accounting issues identified.

   (b) Tentative conclusions reached by the Interpretations Committee.

[1] See http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2014/July/AP16%20-%20IAS%2021%20Foreign%20exchange%20restrictions%20and%20hyperinflation.pdf for agenda paper 16 of the July 2014 meeting of the Interpretations Committee.

(c) Next steps.

4. This paper is for information only.

Background

Foreign exchange controls in Venezuela

5. There are strict Venezuelan government controls over exchanging VEF. The exact nature of these controls has changed, and continues to change, over time. We understand that there are currently three official exchange mechanisms in Venezuela. Each of these has different exchange rates, available to different entities for different types of transactions depending upon specific circumstances. Furthermore, there are restrictions on the amount of currency that can be exchanged though these exchange mechanisms.

6. Entities whose functional currency is that of a hyperinflationary economy are required under IAS 29 *Financial Reporting in Hyperinflationary Economies* to state their financial statements in terms of the measuring unit current at the end of the reporting period by applying a general price index. Groups consolidating such subsidiaries translate these inflation-adjusted subsidiary financial statements into the group's presentation currency (for example US$) at the closing exchange rate in accordance with IAS 21.

Summary of submission

7. The submitter has asked the Interpretations Committee to review the current approach for translating and consolidating foreign operations in Venezuela.

8. Below is a summary of the submitter's observations based on the submission and our discussions with the submitter:

   (a) Prevalent practice is to translate foreign operations into the group's presentation currency using official exchange rates.

(b) For operations with a VEF functional currency the official CENCOX fixed exchange rate has typically been used as the closing rate when applying IAS 21 on the basis that it was the only official exchange mechanism available to a group.

(c) In the submitter's experience, such a rate is only available for a relatively limited amount of currency in practice, with the result that a Venezuelan subsidiary may have more cash in VEF than it is able to convert into US$ (and hence repatriate) using the official exchange rate mechanisms.

(d) Because of foreign exchange controls, the official exchange rates for VEF (in particular the fixed CENCOX and variable SICAD I rates) do not, according to the submitter, reflect the local rate of hyperinflation. Hence, in the submitter's view, a substantial devaluation of the VEF from the official fixed exchange rate in the future is almost certain.

9. As a consequence, the submitter is concerned that, from an economic perspective, the financial statements of group accounts appear not to appropriately reflect:

(a) the Venezuelan operation's assets and liabilities (including local cash held in VEF);

(b) income from the Venezuelan operations (which is further compounded by the IAS 29 inflation adjustments); and

(c) foreign exchange losses (or gains) in profit or loss arising on US$ (or other non VEF) denominated balances in Venezuela.

Primary accounting issues

10. On the basis of the concerns raised, the accounting issue primarily stems from the closing rate used on the application of IAS 21 on translation of the net investment in the foreign operation, because there are (i) several different exchange rates and (ii) control restrictions over both the exchange *rate* and the *amount* of local cash that can be exchanged.

11. The primary issues identified by the Interpretations Committee are therefore:

    (a) Issue 1: which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?

    (b) Issue 2: what rate should be used when there is a longer-term lack of exchangeability?

Tentative conclusions reached by the Interpretations Committee

12. When assessing the accounting issues identified above, the Interpretations Committee considered:

    (a) the results of outreach from securities regulators, members of the International Forum of Accounting Standard Setters and the IFRS technical teams of the international networks of large accounting firms; and

    (b) the agenda criteria of the Interpretations Committee described in paragraphs 5.16–5.17 of the IFRS Foundation *Due Process Handbook*.

Issue 1: which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?

13. Issue 1 arises because there is no specific guidance in IAS 21 regarding which exchange rate, out of multiple rates, to select for the purposes of translating an entity's net investment in the foreign operation. However paragraph 26 of IAS 21 does give guidance on which of multiple exchange rates to use when reporting foreign currency transactions in the functional currency in the local entity's financial statements.

14. The Interpretations Committee tentatively decided not to take Issue 1 onto its agenda, as outreach indicated little diversity in practice regarding the principle to use when determining which of multiple rates should be used to translate an entity's net investment in a foreign operation. It observed that general practice is

to use the exchange rate at which the entity will be able to remit funds from its foreign operations (ie the rate at which future cash flows could be settled when viewing the net investment as a whole), which is consistent with the principle in paragraph 26 of IAS 21.

Issue 2: what rate should be used when there is a longer-term lack of exchangeability?

15. Issue 2 arises because of the longer-term lack of exchangeability of the local currency, which the Interpretations Committee observed to be:

    (a) widespread;

    (b) leading to some diversity in practice; and

    (c) not addressed by the requirements in IAS 21, so that it is not entirely clear how IAS 21 applies in such circumstances.

16. Outreach indicated that the concerns raised due to foreign exchange restrictions faced by foreign operations in Venezuela are valid. However, the Interpretations Committee noted that Issue 2 could not be addressed through an interpretation of the Standard or an Annual Improvement, as to do so would require an exception to the definition of ‘closing rate’ in IAS 21.

17. The Interpretations Committee considered whether to take the issue onto its agenda with a view to developing a recommendation for an amendment to IAS 21 for the IASB’s consideration, after consulting the IASB. Staff highlighted that developing such a solution might be difficult in practice because it would require a new or different principle from that currently in IAS 21 and could lead to questions about the basis for all foreign currency translations under IAS 21. Furthermore, this issue cuts across other issues that have been raised to the IASB with respect to IAS 21, which potentially could impact the scope of any proposed solution to the issues raised.

18. Consequently, the Interpretations Committee tentatively decided not to take the issue onto its agenda, but to highlight the issue to the IASB. The IASB’s current agenda includes research projects on foreign currency translation and inflation,

with the aim of considering whether there are issues that the IASB should address and, if so, what the scope of such a project should be. Therefore this issue might be more appropriately considered as part of that assessment.

19. The Interpretations Committee also decided to highlight in its tentative agenda decision that some of the existing disclosure requirements in IFRSs apply in such circumstances, as noted in the extract from the IFRIC Update for July 2014 in Appendix A.

Next steps

20. The Interpretations Committee will consider any comments received on its tentative agenda decision at its meeting in November 2014.

21. In addition, a preliminary paper on the IASB's research project on foreign currency translation will be discussed by the IASB by the end of 2014.

Appendix A—Extract from IFRIC Update for July 2014

Interpretations Committee tentative agenda decisions

IAS 21 *The Effect of Changes in Foreign Exchange Rates*—Foreign exchange restrictions and hyperinflation (Agenda Paper 16)

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) what 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 practice regarding the principle to use when determining which of multiple rates should be used to translate an entity's net investment in a foreign operation. The Interpretations Committee noted that predominant practice is to apply by extension 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 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 this issue is widespread and has led to some diversity in practice. 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. However, the Interpretations Committee thought that addressing this issue is a broader-scope project than it could address (because of related cross-cutting issues). 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 settle the liabilities of the group, or its joint ventures or associates (paragraphs 10, 13, 20 and 22 of IFRS 12).