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## **Draft Comment Letter on the IASB's Exposure Draft *Lack of Exchangeability* Cover Note**

### **Objective**

- 1 On 20 April 2021, the IASB published Exposure Draft *Lack of Exchangeability* (the ED), with a 120-day comment period ending on 1 September 2021.
- 2 The objective of the session is to discuss EFRAG's draft comment letter on the ED (the DCL) and to agree to recommend the DCL to the EFRAG Board.

### **Background**

- 3 IAS 21 The Effects of Changes in Foreign Exchange Rates provides the requirements regarding how to account for foreign currency transactions and operations in financial statements, and also how to translate financial statements into a presentation currency. An entity is required to determine a functional currency (for each of its operations if necessary) based on the primary economic environment in which it operates and generally records foreign currency transactions using the spot conversion rate to that functional currency on the date of the transaction
- 4 IAS 21 generally requires the use of a spot exchange rate when an entity reports foreign currency transactions or a foreign operation's results and financial position in its financial statements. IAS 21 specifies the exchange rate to use in reporting foreign currency transactions when exchangeability between two currencies is temporarily lacking,
- 5 However, IAS 21 does not provide any specific requirements on what exchange rate a reporting entity uses to translate the results and financial position of a foreign operation when a lack of exchangeability is not temporary.
- 6 The IASB has observed that those circumstances existed in Venezuela when the issue was taken to the IFRS Interpretations Committee in June 2018. In Venezuela, the jurisdictional authorities administer the exchangeability of the currency and allocate foreign currencies to entities/individuals mainly through an auction-based mechanism. The jurisdictional authorities set an official exchange rate that prevents the official exchange rate from being a free-floating rate. Furthermore, the entities have been unable for several years to exchange the currency to repatriate dividends or make investment-related payments.
- 7 The IASB has also observed that, in the past, diverse views on how to determine whether a currency is exchangeable into another currency, and which exchange rate to use when it is not, were developed by preparers. In the IASB's view diversity in practice could lead to material differences in the financial statements of entities affected by a currency that lacks exchangeability.

- 8 Moreover, for hyperinflationary economies (which may also be accompanied by lack of exchangeability as well as it may be a separate issue), IAS 29 *Financial Reporting in Hyperinflationary Economies* requires the reporting entity to firstly restate non-monetary assets and liabilities of the foreign subsidiary to reflect inflation by applying a general price index before retranslating subsidiary's financial statement into reporting currency.

### **The proposed guidance and its scope**

- 9 In order to respond to the issues related with exchangeability of currency, the IASB proposes to amend IAS 21 and to specify:
- (a) when a currency is exchangeable into another currency and, consequently, when it is not;
  - (b) how an entity determines the exchange rate to apply when a currency is not exchangeable; and
  - (c) the information an entity provides when a currency is not exchangeable.
- 10 EFRAG notes that the proposed guidance would apply to a wider range of situations where the local currency lacks exchangeability due to the economic or political environment. Consequently, the scope of the guidance would apply not only to the exchangeability of Venezuelan local currency, but also to other currencies. Furthermore, the proposed guidance would also apply, to single transactions, and not only for translating financial statements of foreign operations for the purpose of consolidation.

### **Previous consultations with EFRAG TEG and EFRAG Working Groups**

- 11 EFRAG already discussed the expected proposal with EFRAG TEG and EFRAG CFSS on 2 December 2020 and with EFRAG FIWG on 24 February 2021, where the respective members provided comments on the planned proposals.
- 12 The feedback received is as follows. The members highlighted that:
- (a) the proposed amendments to IAS 21 could be helpful, however, they are coming late; the main reason is that the groups already had to consider the translation of foreign activities operating in hyperinflationary economies;
  - (b) the additional disclosures may do add value, however, for material subsidiaries, IAS 1 disclosure requirements would also play their role;
  - (c) they agree that the deconsolidation method in such circumstances does not seem to be a proper approach because the liabilities of the investee will be removed from the statement of financial position of the group, but would still carry liquidity risk for the group.

The members also

- (d) generally welcomed the IASB proposal to amend IAS 21 to address the issues related to exchangeability of a currency. In particular, the members supported the IASB's attempt to provide a definition of exchangeability of a currency. In their opinion this would reduce the divergence in practice and reduce the operational burden. They supported the principle-based approach, however they also wondered whether the proposed guidance is detailed enough to assist preparers in more complex situations.
- (e) supported that the proposals may apply to a wider range of other jurisdictions (e.g. Argentina or countries in Africa), and will not be limited to the Venezuelan jurisdiction only.
- (f) noted also that some companies may arrive at a conclusion that a currency is exchangeable while other companies may arrive at an opposite conclusion.

- (g) suggested the EFRAG Secretariat to conduct a limited scope research to verify the number of jurisdictions that could be affected by the proposals.

#### **EFRAG Secretariat draft DCL**

- 13 The EFRAG Secretariat initially assesses that the proposals may have a positive impact on financial reporting under IFRS and may reduce the divergence in practice in regard to accounting for foreign transactions and operations where foreign currency lacks exchangeability.
- 14 Nevertheless, the EFRAG Secretariat proposes to request the IASB to clarify / amend the notion of the spot exchange rate, in order to align it with the notion of administrative delay.
- 15 Furthermore, EFRAG Secretariat initially agrees with the guidance regarding how to determine a spot exchange rate and we do not propose suggesting the IASB to add details requirements on the financial formula that should be used to adjust the observable rates for inflation, discounts etc. However, we propose to request the IASB to provide a numeric example to guide preparers on how the estimation process should look like in practice. Therefore, to better understand the process we also propose to ask constituents what techniques they actually use to adjust the observable rates.
- 16 Finally, we suggest asking constituents about eventual further information needs regarding the situations where a currency lack exchangeability.

#### **Planned outreaches**

- 17 EFRAG Secretariat, apart from publishing the DCL in order to receive constituents' comments, also plans to further consult the DCL with EFRAG Working Groups: RRAWG, IAWG, and EFRAG User Panel.
- 18 Furthermore, we propose to discuss the proposed amendments with the members of EFRAG CFSS.
- 19 Based on the results of a research, we also plan to discuss the proposals with NSS that may expect a significant impact of the proposals on the financial statements of companies in their jurisdiction.

#### **Questions for EFRAG TEG**

- 20 Do EFRAG TEG members have comments on the EFRAG's draft comment letter on the ED?
- 21 Do you agree to recommend the draft comment letter to the EFRAG Board?
- 22 Are you aware of any other jurisdictions for which "lack of exchangeability" is a well known problem?
- 23 Do you propose other outreach activities for the EFRAG Secretariat?

#### **Agenda Papers**

- 24 In addition to this cover note, Agenda Paper 09-02 – *Draft Comment Letter* has been provided for the session.
- 25 The ED is available on the IFRS Foundation web site on IFRS Foundation's website: <https://www.ifrs.org/content/ed2021-4-lack-of-exchangeability-ias-21.pdf>