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This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

The IASB ED *Lack of Exchangeability* Summary of Feedback Received

Background

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. In the ED, the IASB proposed to amend IAS 21 *The Effects of Changes in Foreign Exchange Rates*. In response to the ED, on 3 June 2021, EFRAG published its draft comment letter (the DCL) and asked for constituents' views by **26 August 2021.**

2 This paper provides a summary of the feedback received from EFRAG's outreach activities, what included EFRAG public and private meetings, and closed meetings with constituents. The summary of the formal comment letters received in response to EFRAG DCL is provided in Paper 02-03 for this session.

3 This paper summarises the feedback collected by the EFRAG Secretariat on the IASB's ED and EFRAG's DCL during the following meetings:

(a) Public EFRAG TEG and CFSS meeting held on 16 June 2021;

(b) Public EFRAG TEG and User Panel meeting held on 20 June 2021;

(c) Non-public meetings with EFRAG FIWG (held on 1 July 2021) and EFRAG IAWG (held on 7 July 2021).

4 Moreover, EFRAG Secretariat collected feedback on existing and past practises related to the situations of lack of exchangeability, and initial reactions to the IASB's ED and EFRAG's DCL, during eight closed meetings held with:

(a) Two preparers with the activities affected by lack of exchangeability of a local currency (on an anonymous basis);

(b) IFRS Technical Desk representatives of five professional firms: BDO, Deloitte, PWC (Argentina and EMEA), KPMG (written correspondence), and EY (on an anonymous basis).

Summary of the feedback received

Comments by working group

<u>Specific comments on EFRAG`s DCL</u>

5 One constituent noted that a change in functional currency to overcome the situation of a lack of exchangeability should not be addressed as it was a matter of fact and circumstances, and the selection of the functional currency was not a choice.

6 Constituents stated that a proposal for a disclosure relief because of the sensitivity of the situation should not be proposed as it would not be needed, and it would also be difficult to decide when such relief should be applied.

7 Users (analysts) stated that disclosures on the assumptions used would be crucial to understand the assumption taken and the effects on the financial statements.

Comments by audit companies

General comments on the issue of lack of exchangeability

8 Outreach participants stated that there would be a number of currencies that are not freely convertible as there is heavy influence of politics on exchange rates, but Venezuela is the base case. In past practice the official rate was taken, but as several rates emerged preparers in practice got confused. When no economic reasonable rate was offered, preparers started to estimate but the range were huge.

Countries in the scope of the ED

9 Participants expressed their view that in addition to Venezuela also the following countries were in scope:

(a) Lebanon (many participants agreed)

(b) Argentina (many participants agreed)

10 Some participants stated that other countries could also be in scope (e.g., African countries like Zimbabwe, but it was not clear).

General comments on the ED

11 Most participants welcomed the IASB`s proposals to give more guidance on the lack of exchangeability, but many also stated that the approach taken would give some judgement for the estimation.

12 Some participants highlighted the complexity of the proposals, so that one participant sought for simplification and other participants stated that they would prefer usage of an official exchange rate or the most relevant observable exchange rate as estimation would be very subjective. Those also stated that a company should only deviate from the official exchange rate in extreme situations and the use of the official rate should always be allowed for comparability reasons. One participant suggested to use a rebuttable presumption with a high level of probability.

13 One participant highlighted some detailed issues that would make it difficult to determine a lack of exchangeability:

(a) Normal administrative delay of seven days would be too restrictive;

(b) Exchangeability between currencies is not a problem, rather the exchange from the currency that is lacking exchangeability into another currency, therefore the description may prevent from identifying a lack of exchangeability.

(c) The notion of enforceability should be clarified and the factors in paragraph A13 of the ED should be redeliberated, if those would be useful and clearly understood.

Estimation process

14 Participants generally argued that estimating the exchange rate would be very subjective due to a multitude of possible adjustments. Some participants also expressed their concern that the foreign currency translation of subsidiaries in the same country with different exchange rates depending on their business model would not support comparability.

15 Some participants also argued that:

(a) Estimating a rate would result in rates that are often very close to parallel market rates. One participant from an audit company also noted that this could be used as a plausibility check for the estimated rate.

(b) An estimated rate will never result in an exchange transaction but could be manipulated by the preparer.

(c) Companies would often use advisors for the calculation and those would calculate differently thus comparability would be affected.

Those participants stated that estimation should not be allowed and the official rate or another rate (e.g., observable rate for other transactions; on a legal parallel market) would be the preferred exchange rate.

16 The use of inflation differentials for estimating an exchange rate as stated by some participants would not always be straight forward as information on inflation rates would not always be reliable. Other methods (interest rate differentials) could be excessively complex.

17 Those participants that supported estimation pointed out that ED`s lack of guidance on the estimation process would have to be addressed by the IASB to ensure that companies would make consistent and reasonable estimates. To support this objective, they suggested that:

(a) A framework for measurement and examples should be introduced;

(b) The Framework should use an input hierarchy to ensure alignment with IFRS 13 *Fair Value Measurement* and the use of observable input factors. Therefore, some participants suggest redeliberating the diagram provided in paragraph A1 of Appendix to the ED, to support the use of observable rates. The conditions for a lack of exchangeability should also represent the basis for the estimation process (e.g., legal exchangeability) requiring clarifications on the use of black-market (or parallel market) rates in the estimation process either directly in the guidance or in the Basis for Conclusions of the final amendments (as currently different interpretations exist).

(c) Consequently, a clarification for the use of black-market rates seems necessary as the use of such rates has resulted in different view because parties interpret the ED differently:

(i) Would not be allowed as an input into the estimation process;

(ii) Would be allowed (due to the current drafting of the ED), but should not be allowed and used;

(iii) Would be allowed and used as an evidence or a starting point for the estimation process.

<u>Disclosures</u>

18 User participants noted that disclosures would be important to have the opportunity to deconsolidate and strip out companies that have a Lack of Exchangeability. One user had doubts regarding the usefulness of full consolidation, whereas it was agreed in general that the control criteria in IFRS 10 *Consolidated Financial Statement* would drive deconsolidation.

19 Participants stated that disclosures would be relevant:

(a) One user participant suggested to include disclosures on accumulated reserves for translation to the exchange rate in the consolidated financial statements would be useful (accumulated exchange differences since lack of exchangeability occurred).

(b) One user participant suggested to disclose:

(i) Rate used

(ii) Amount of transaction

(iii) Sensitivities

(iv) Information on entities judgement for estimation

Comments by preparers

20 A participant elaborated on the situation in Lebanon were different rates existed (official rates/preferred rates, unofficial rates etc.), but official rates would not reflect economic reality. Foreign currency translation in the past were made using the official exchange rate as other rates were not accessible. The participant welcomed the IASB`s efforts and the approach taken, but raised concerns about the application of estimation techniques, thus more guidance for such estimation would be required, otherwise discussions with the auditors would be burdensome.

21 Participants elaborated on the situation in Argentina where different rates existed (official rates, Blue Chip Swap rates, unofficial rates published in the newspapers etc.), but official rates would mostly only be accessible by exporting/importing companies, but those did not reflect economic reality. For other companies the exchange of currency is not forbidden, but there would be a de facto prohibition as Central Bank would simply not make the exchange. One Argentinian preparer expressed concern on the approach, although not affected by the lack of exchangeability itself, as the estimation would lead to different and therefore less comparable results related to

(a) similar companies in the same country; and

(b) maybe also to different items in the financial statement.

Detailed comments

Specific comments on EFRAG DCL

22 One WG member noted that the wording in paragraph 15(d) should be changed as the functional currency was a matter of fact. Unless facts and circumstances would change, the selection of the functional currency was not a choice.

23 Two user participants stated that no special exemption on disclosures would be needed. There was no need to exempt sensitive disclosures and the analyst was not sure how to draw the line for a situation that justify such an exemption and those that not.

24 One WG participant stated that the DCL is relatively too detailed for such a small amendment, so maybe – based on the narrow scope of the proposed amendments – the issues in the DCL and its requests may be limited to disclosures only.

25 One participant planned to comment on the ED with the following preliminary views:

(a) A general support for the proposals; and

(b) The IASB should require the use of an available observable rate (that meets the conditions in paragraph 19A of the ED) as it would decrease diversity in practice, increase comparability and enforceability.

26 Two European NSS stated that the topic was not seen very often in practice in their jurisdiction.

General comments on the issue of lack of exchangeability

27 One audit firm noted that basically there are a number of currencies in the world that are not freely convertible, so there is heavy influence of politics on exchange rates.

28 Three audit firms noted that Venezuela was the basic case for the first years and in practice the official rate was taken . Subsequently, several rates were introduced for translating foreign currency amounts and as a consequence the case was submitted to IFRS Interpretations Committee because diversity in practice existed of how to deal with that issue as also government stopped publishing inflation rates.

Corporates started to use estimated rates, because using the official rate would overstate the amounts. But the range of rates that were used was vast.

29 One participant noted (regarding the Argentinian case) that it seemed that some parent companies in Europe had the feeling that some of their subsidiaries in Argentina would not reflect economic reality by using the official exchange rate for translation, therefore the issue was prevalent in this jurisdiction and the IASB sought for a solution.

Countries affected

30 Several constituents stated that they would see the following countries in the scope:

(a) Venezuela – however the effect, in most cases, is not material anymore because the assets have already been impaired; (most participants)

(b) Lebanon (most participants)

(c) Argentina (most participants)

(d) Some participants stated that some discussion evolves around other countries like Iran and Syria or some African countries, but it is not definitive whether those would satisfy the criteria of lack of exchangeability of local currency.

31 Two preparer participants stated that they operate in a high inflationary environment, where lack of exchangeability exists:

(a) One preparer noted that the company suffers the problem of lack of exchangeability in Lebanon as it cannot withdraw more than an insignificant amount from its dollar account in Lebanon. However, the local company is independent from its parent company for regulatory reasons, so the company acts as financially independent. If contributions are required, it is sufficient to demonstrate the money on a European bank account (something like a fiduciary amount on a fiduciary account). The company is currently using the official exchange rate of Lebanon, which is not believed to have any economic substance.

(i) Exchange rate did not change for many years, and no one would exchange money for this official rate.

(ii) There is also a preferred rate for certain products, but the preferred rate is not generally accessible.

Currently, there is no other way than to exchange currencies at the official rate. Consequently, assets value has grown significantly due to changes in prices, and the exchange rates being at an unchanged level.

(b) One preparer noted that the local circumstances in Argentina could result in satisfying the criteria of lack of exchangeability as the chances for the company to exchange money (into US-Dollar) would depend on the business that the company operates. Every time the company exports goods, the company is required to deposit the funds in an Argentinian bank, and exchange it to local Argentinian Peso using the official exchange rate within a certain time period. This preparer also noted very high import and export taxes charged on the turnover of import or export.

32 One preparer noted (regarding the Argentinian case) that subsidiaries in Argentina did not reflect economic reality using the official exchange rate, therefore the issue was prevalent especially in this jurisdiction. The participant further stated, although it is not legally prohibited, Central Bank will not pay out foreign currency even after the company hands in the documentation for application (de facto prohibition).

33 The case of Argentina was described by two constituents (one audit firm and one preparer). Based on their description Argentina offers the following rates:

(a) An official rate, whereby the transaction is taxed at different (and significant) tax rates depending on the underlying transaction . The problem is that currently there is a very large difference between the official rate and other rates available for exchange.

(b) Blue Chip Swap transaction rates (traded debt/bonds that are sold both on local market in local currency and in foreign currency abroad, e.g., in US Dollar in the USA) Blue Chip Swap transactions always require a trade to get the money and the bonds must be on the entity's balance for a short retention period. It is not allowed under current IAS 21 to take such "exchange" rate for translation as it is a trading transaction. It seems that under the ED, Blue Chip Swap transactions would be allowed to be used as an input to the estimation of a spot exchange rate.

(c) Parallel market rates are often published in the newspapers in Argentina.

Comments on the ED

34 Most of the participants welcomed the IASB`s proposals to give more guidance on the lack of exchangeability issue and many participants stated that the overall approach taken is useful, but the exposure draft gives some judgement for the estimation of rates. . Some participants stated that it was unclear whether the ED makes things simpler or more complicated, so

(a) one participant stated that the IASB should simplify the approach ;

(b) two participants stated that the official rate should be used or the most relevant exchange rate within a range of rates.

35 The participants under (b) above, stated that the estimates would be very subjective and therefore most audit companies traditionally refused to allow the use of estimated exchange rates. The company should only deviate from official rate in extreme situations, which could be understood like a rebuttable presumption with a high level of probability. The determination should be made at a country level. The use of the official rate should always be allowed as this would support comparability better. But diversity in practice should be avoid because a Lack of Exchangeability itself would probably not result in a loss of control under IFRS 10 *Consolidated Financial Statements*, therefore such approach should be prevented.

36 Members from the EFRAG User Panel had the following general comments on the topic:

(a) One user participant noted that the main issue was that the risk was that not clarifying the method to use, allowed for a very broad range of exchange rates. Maybe the exchange rate could be linked to what the ECB thought was a fair exchange rate.

(b) Two user participants stated that disclosures would be important to have the opportunity to deconsolidate and strip out companies that have a Lack of Exchangeability. Many of the issues the exposure draft was trying to address were practical matters for entities owning a subsidiary in countries like Venezuela and having to produce a set of accounts, therefore the needs were different from what analysts would need. However, any guidance reducing the range of exchange rates used would be beneficial.

(c) One user participant added that if might be helpful to know about dependencies of the company on supplier that would need to be paid in hard currencies and also information on practical issues to pay those suppliers. Another user mentioned that such disclosure would already be covered by the proposed amendment (paragraph 11 (a) – (e)).

(d) One user participant noted from his view that he had doubt about the usefulness of information, if those subsidiaries are fully consolidated, although the user admitted that control was the driving force for (de-)consolidation. The user participant recalled an example where parent had recorded a Venezuelan subsidiary on a certain exchange rate, and because of the rate applied it had appeared as if the company as a whole had been growing. High inflation and lack of exchangeability appeared to be interrelated. This may not directly be identified by analysts.

(e) Another user participant stated that a disclosure on accumulated reserves for translation to the exchange rate in the consolidated financial statements would be useful to have a measure for differences between the status quo and the state before the Lack of Exchangeability occurred.

37 One participant expressed the view that there would be a variety of useful disclosures that could help to give better insights into the Lack of Exchangeability problem. The participant suggested that the following disclosures would be needed:

(a) Rate used

(b) Amount of transaction

(c) Sensitivity analysis

(d) Info on the judgement and how the mechanism works

38 One participant noted that a normal administrative delay of seven days would be too restrictive and open up the scope for a variety of countries, where companies operate with a delay of months. The participant also stated that exchangeability between currencies is not a problem, rather the exchangeability from one currency into another currency as it is mostly very easy to buy currency from such jurisdiction that are meant to have a lacking exchangeability (e.g., buy Lebanese Dollar or Lebanese Pound with US Dollar is not an issue).

39 Other comments by one audit firm:

(a) There should be a clarification on the meaning of enforceability (right or obligation);

(b) Factors to consider in A13 should be reconsidered:

(i) Not possible to separate out incentives and penalties;

(ii) Use the least advantageous rate if another observable rate exists;

(iii) Explain A13 (c) more closely or remove;

(iv) A13 may take into account unofficial/illegal/parallel market currency exchange rates.

Estimation process - general comments on estimation

40 Participants generally argued that estimating the exchange rate would be very subjective as the calculation process could incorporate all kinds of adjustments. Even if the lack of exchangeability came along with high inflation rates, information on inflation would probably not be reliable or causes other issues:

(a) Inflation rates by published state agencies could be impaired for economical/political reasons.

(b) Estimating a rate is not useful (merely redundant) as estimated rates are often very close to parallel rates (like black market rates) and technically the preparer will never come to a rate that is the real exchange rate.

(c) An estimated rate will never result in an exchange transaction but could be manipulated by the preparer.

(d) Companies would often use advisors for the calculation and those would calculate differently (based on the firm engaged) thus comparability would be affected.

Some participants stated that estimation should not be allowed and the official rate or another rate (e.g., observable rate for other transactions; on a legal parallel market) would be the preferred exchange rate. One participant specifically stated that estimation could not be improved as those countries would mostly have corrupt or missing data.

41 If estimation would be allowed, participants pointed out that the IASB would have to address the ED`s lack of guidance with regards to the estimation process. Companies would have to make consistent and reasonable estimates. Moreover, participants provided the following notes and statements

(a) Some participants noted that there should be a framework for measurement in general and it would be helpful to get some illustrations without being too specific;

(b) Many participants stated that there should be an input hierarchy and the companies should use as much observable input factors as possible (e.g., most liquid rate or most reliable data). The IASB should provide an example for the calculation if no rate could be observed. There should also be a link to IFRS 13 *Fair Value Measurement*. Therefore some participants suggested that the flow chart should be changed (reworked, e.g., mandatory use of alternative observable rates);

(c) One participant stated that the conditions for a lack of exchangeability should also represent the basis for the estimation process (e.g., legal exchangeability).

(d) One participant stated that it is not possible to provide a model that works in all cases, but there should be a description what adjustments would be appropriate/acceptable.

(e) Two participants stated that the IASB should give more disclosures to support the understanding of the translated balances, so also that audit companies and analysts can assess how the companies have calculated the rate used. From an audit perspective it would be strange to calculate a rate that is dissimilar to the official exchange rate or to a legal parallel rate (e.g., the BlueChip Swap rate in Argentina).

42 One participant also stated that to use interest rate differentials would be more sophisticated and thus this method would be used in rare circumstances. For cases where no inflation data exits, it seems that there is some need to look for observable rates otherwise it would be unclear how to solve the problem. In those cases, it would be difficult to know how the estimation process should work, otherwise alignment with auditors would be a burdensome and complex.

Example of a lack of exchangeability in Lebanon

43 The situation in Lebanon would be similar to the situation in Venezuela, so the Lebanon situation would be a good test case for the proposed guidance. One participant stated that in his opinion the outcome of applying the exposure draft in Lebanon would not be clear.

44 Some participants took the position that in Lebanon inflation rate differentials used to calculate the exchange rate would be the best approach to estimate an exchange rate. One participant stated that there seems to be, although it is hyperinflationary, sufficient data about inflation rates to execute an estimation in this jurisdiction.

45 Some participant agreed on the statement that black-market rates are not legal and lead to a problem with IAS 21 in its status quo, so those should not be considered as an exchange rate in Lebanon. With regard to the use of non-legal parallel rates in the context of the exposure draft the participants had different opinions:

(a) Few argued that black market rates (or parallel rates) should not be used (not even as a starting point for estimation), although they were aware that some people called for the use of black-market rates in some parts of Africa.

(b) Few argued that the use of black-market rates would not be precluded as an input in the estimation process, but those stated that this should not happen as they were sceptical on their use.

(c) Some argued that the use of black-market rates would not be precluded as an input (an evidence of a rate as an input) in the estimation process and that they would even expect that the estimation process would lead to a rate that is similar.

46 One participant further elaborated on the issues of such rates:

(a) Parallel rates might be flawed as the data quality is bad and probably the “trader” tries to get as much money as possible (“fee”).

(b) A consistent calculation methodology does not exist.

Lack of exchangeability in Argentina

47 One participant suggested to introduce a hierarchy meaning that

(a) Exporting/importing companies should use the official rate;

(b) Other would have to take another rate (preferably a rate that is observable);

(c) All other must estimate (probably based on a non-legal parallel market rate).

48 Two participants from Argentina worried that due to the exposure draft balances would be translated with different exchange rates based on the transactions and on the business models. Such process would heavily affect comparability. One participant stated that, generally, (i.e., not specific to Argentina) a reasonably calculated estimate, even with a wide range of different subsidiaries, could not lead to an adverse opinion. Contrary to that one participant stated that an estimate different from an observable rate in Argentina should not be acceptable.

49 One preparer participant from Argentina also worried how inflation rates should be estimated (e.g., when relevant statistics are missing or misleadingly influenced by local government).