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Dr Andreas Barckow
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Our ref RD/288

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Dear Dr Barckow,

Response letter on Lack of Exchangeability

We appreciate the opportunity to comment on the International Accounting Standards Board's (the Board) *Exposure Draft Lack of Exchangeability*. We have consulted with, and this letter represents the views of, the KPMG network. In summary our views are as follows:

— We agree with the proposed principle to estimate a rate if there is lack of exchangeability between two currencies.

— We would recommend additional guidance in respect of possible estimation techniques and more examples on how an entity estimates a rate.

Please contact Colin Martin (colin.martin@kpmgifrg.com) or Reinhard Dotzlaw (reinhard.dotzlaw@kpmgifrg.com) if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix

Question 1
Paragraph 8 of the draft amendments to IAS 21 specifies that a currency is exchangeable into another currency when an entity is able to exchange that currency for the other currency. Paragraphs A2–A11 of [draft] Appendix A to IAS 21 set out factors an entity considers in assessing exchangeability and specify how those factors affect the assessment. Paragraphs BC4–BC16 of the Basis for Conclusions explain the Board's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

We agree with the general principle of estimating a rate when exchangeability is lacking because using an official exchange rate does not provide meaningful information to users of financial statements when market participants cannot access the official rate.

We believe that the factors set out in paragraphs A2-A11 of the ED are generally suitable for the assessment of whether a rate is exchangeable or not. However, we believe that further guidance is required in respect of what is a normal administrative delay in obtaining another currency. Where capital controls exist, a normal administrative delay may be very different to circumstances where there are no such capital controls. It would be helpful if the standard made clear that the assessment of a normal administrative delay should consider the particular facts and circumstances of the jurisdiction where the assessment is being made.

We would also propose that the amendments clarify that exchange mechanisms need to create enforceable rights and obligations only as part of step I, i.e. for the purpose of assessing whether the currencies are considered to be exchangeable. Parallel or black markets (where no enforceable rights and obligations are created) might still be considered as part of the estimation of a rate in step II (i.e. estimating a rate after it is concluded that exchangeability is lacking) if they provide useful information.

While we agree with the principle that the purpose for which the foreign currency and the amount that can be obtained are important factors to consider, we believe that there is a need for further clarification as to how these requirements are applied. For example, paragraph A11 discusses a situation where only an insignificant amount of foreign currency can be obtained, however it does not explain what happens if the amount of foreign currency that can be obtained is not insignificant, but is still limited and is less than the foreign currency position.

Illustrative Example 3 states that the ability to obtain a currency for certain purposes (importing food and medicine in the example) is irrelevant to the *assessment* of the lack of exchangeability in respect of translation to the presentation currency, however, it

does not expand on what to do once that assessment has been made in terms of the estimated rate to be applied. BC 11 makes it clear that the rate used in translation to presentation currency is the estimated rate for realisation for all of the net assets of the operation. However, if the balance sheet of the operation consisted of only cash held for the purposes of importing food and medicine, the rate that could be obtained for realisation of the net assets of the entity would presumably be different to the rate that could be obtained if the cash held in the operation was insignificant. It would be helpful if IE3 could be expanded to cover the additional factors that the entity considers in estimating the rate for exchange into the presentation currency.

Given that the use of multiple exchange rates in a single set of financial statements is clarified as being appropriate (as stated in paragraph 26 and confirmed in BC 10), there are potentially additional complexities that the ED should provide guidance on:

For example, an entity in a jurisdiction where exchangeability with the USD is lacking might be *able to sell* all its USD for local currency only at the official exchange rate, but it might not be able to *acquire* USD to settle USD liabilities at the official rate because market participants are not *willing to sell* USD at the official rate. One possible interpretation of the ED is that the entity would have to translate its USD assets at the official rate while translating its USD liabilities at a different estimated rate, leading to a mismatch in translating assets and liabilities. Such a presentation would not provide meaningful information to users if USD assets are held to settle USD liabilities. We believe that the ED should be clarified that foreign currency liabilities that are intended to be settled using existing foreign currency assets are (to the extent covered) translated using the same rate as those related assets.

In some jurisdictions where local currency lacks exchangeability with other currencies, laws and regulations provide for a certain amount of foreign currency per month that market participants can buy from the government. In that case, it is not clear if entities would need to translate a pro rata share of each outstanding balance using the official rate and the remaining share using an estimated rate. It would be helpful if the ED provided a further illustrative example of that situation.

Question 2
Paragraphs 19A–19C and paragraphs A12–A15 of the draft amendments to IAS 21 specify how an entity determines the spot exchange rate when a currency is not exchangeable into another currency. Paragraphs BC17–BC20 of the Basis for Conclusions explain the Board's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

Paragraph 19A sets out the conditions an entity has to meet when estimating a rate. We generally agree with these conditions, but note the following points:

Paragraph 19B and A1 contain guidance on how to proceed when exchangeability is lacking. Paragraph 19B allows (but does not mandate) the use of an observable rate for a different purpose or the first available subsequent rate to be used as the estimated rate. It could be inappropriately interpreted that 19B (a) and (b) should be applied sequentially. Doing so would imply that another estimation technique may be used *only* if 19B (a) and (b) estimates are unavailable. The flowchart in A1 also supports the idea of a hierarchy, moving from a preferred approach to a less preferred approach in a sequential order, depending on the availability of each option.

We understand that the principle set out in paragraph 19A is that an estimated spot rate should be used when exchangeability between two currencies is lacking. We would welcome a rewording of paragraph 19B to make clear that the entity should use its judgement to form the best estimate of that spot rate. The techniques shown in 19B (a) and (b) are examples of how an entity could make that estimate, or may use the rates mentioned in 19B (a) and (b) as a starting point, but other methods may be equally as valid.

Appendix A Application Guidance would then contain suggestions as to how an estimate could be reached. Due to the variety of facts and circumstances that create a lack of exchangeability in practice and the differences in laws and regulations that governments implement, possible and common estimation procedures should be pointed out without implying that a hierarchy exists among them.

For example, in Argentina, an extensive market has developed to convert local currency (ARS) into foreign currency (mostly USD). Brokers buy or sell USD denominated securities that are also listed internationally in the local market using ARS and sell or buy them back later in USD internationally (so called blue-chip swaps). Entities can therefore effectively translate ARS into USD and vice versa using this mechanism and the resulting “blue-chip swap rate” is observable and quoted in local newspapers. In Zimbabwe, we have experienced that entities have reverted to using dual pricing for common goods in local shops (shops price in both local ZWD and USD) in order to determine the current market spot rate.

However, in both cases, the ability to impute a currency exchange rate is likely to fail the definition of a spot exchange rate under IAS 21, but may provide a basis for a suitable estimate. We therefore suggest explicitly adding an example that shows how to estimate a rate using observable data for pricing goods and services (such as in either of the two cases above) if this leads to the most appropriate estimate for the relative value of the two currencies.

We would also welcome guidance when entities may have access to only limited amounts of currency. For example, in Nigeria, foreign currency is allocated to market participants subject to availability. As a result, it is unclear when the market participant will receive its allocation. Entities can typically obtain some foreign currency at the official rate and need to acquire additional foreign currency for immediate demand at the (higher) parallel market rate. In making an estimate of the appropriate exchange rate, it is not clear whether an entity should use a blended rate, weighting the two

estimates to best reflect the economic conditions at the reporting date, or alternatively use the most prevalent rate.

Question 3
Paragraphs 57A–57B and A16–A18 of the draft amendments to IAS 21 require an entity to disclose information that would enable users of its financial statements to understand how a lack of exchangeability between two currencies affects, or is expected to affect, its financial performance, financial position and cash flows. Paragraphs BC21–BC23 of the Basis for Conclusions explain the Board's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

We agree with the proposed disclosures.

We suggest adding some consideration of the levelling disclosures required under IFRS 13. While the disclosures required by paragraph A17 provide quantification of the carrying amounts of the assets and liabilities that are affected by a lack of exchangeability, that disclosure is not linked to the fair value hierarchy. We believe that users need to be informed as to the effect on the levelling disclosure from the use of estimated exchange rates.

For example, consider Entity Y that consolidates its Foreign Operation X. Entity X holds only Level 1 listed securities. There is a lack of exchangeability between the functional and presentation currency of Entity Y and the functional currency of X. It is not clear how the values of Entity X's assets that are based on an estimated exchange rate should be presented in the levelling disclosure in the group financial statements. We recommend that additional guidance is provided in the disclosure section of the ED.

Question 4
Paragraphs 60L–60M of the draft amendments to IAS 21 require an entity to apply the amendments from the date of initial application and permit earlier application. Paragraphs BC24–BC27 of the Basis for Conclusions explain the Board's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

We have no comments on the proposed transition requirements.