European Securities and Markets Authority

The Chair

Date: 17 April 2019

ESMA32-63-699

Sue Lloyd
Chair of the IFRS IC
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Agenda Item Request: Application of hyperinflationary accounting

Dear Mrs. Lloyd,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that enhances the protection of investors and promotes stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of its supervisory convergence work in the area of financial reporting, I would like to raise with you the following application issue related to the interaction of IAS 21 *The Effects of Changes in Foreign Currency Rates* and IAS 29 *Financial Reporting in Hyperinflationary Economies*.

As a result of work carried out by national competent authorities and ESMA's coordination activities regarding supervision and enforcement of financial information prepared in accordance with IFRS, ESMA has noted a lack of clarity concerning the implications of the first-time application of hyperinflationary accounting by a foreign operation whose currency has become the currency of a hyperinflationary economy on the consolidated financial statements of a group presented in the currency of a non-hyperinflationary economy.

The development whereby Argentina as a major economy and a G20 member became hyperinflationary during 2018 has highlighted that some of the guidance in IFRS on hyperinflationary accounting is insufficient. The interaction of IAS 21 and IAS 29 at the time of first application of hyperinflationary accounting seems inadequate in some specific areas and leads to diversity in application of IFRS with a material effect. Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements.

While ESMA notes that the IASB decided to remove projects related to high inflation and foreign currency translation from its active agenda upon completion of its latest agenda consultation in 2016[1], ESMA is of the view that the specific issues highlighted in the submission is sufficiently narrow for the IFRS IC to develop a specific proposal to clarify them without the need to fundamentally reconsider the existing accounting guidance. Should the IFRS IC consider that

[1] IASB Work Plan 2017-2021, International Accounting Standards Boards, November 2016

even such a narrow scope project is beyond its remit, ESMA kindly suggests that the IASB considers adding such a maintenance project to its agenda on a timely basis.

A detailed description of the case is set out in the appendix to this letter.

In case you have any questions or comments regarding this letter, I suggest you contact Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Steven Maijoor

Cc: Hans Hoogervorst, Chair, International Accounting Standards Board (IASB)

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of the requirements of IAS 21 and IAS 29 with regards to the first application of hyperinflationary accounting, and to the presentation of the effects of hyperinflationary accounting and translation to the non-hyperinflationary presentation currency. These are applicable in preparation of the consolidated financial statements of a group whose presentation currency[2] is the currency of a non-hyperinflationary economy, but foreign operation of which is located in an economy whose currency has become hyperinflationary, hereafter referred to as the ‘group’ and ‘foreign operation’ respectively.
2. While IAS 29 includes guidance on restatement of financial statements of an entity whose functional currency is the currency of a hyperinflationary economy, it does not provide explicit guidance on the presentation of the financial effect of the application of the inflation index (‘hyperinflationary effect’) in the consolidated financial statements of a group whose presentation currency is the currency of a non-hyperinflationary economy.
3. Similarly, whereas paragraph 39(c) of IAS 21 provides explicit guidance for presentation of resulting exchange differences from translation of the results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy into a different presentation currency in the other comprehensive income (OCI), no equivalent guidance has been provided in IAS 21 for the presentation of resulting exchange differences from translation of a ‘*hyperinflationary*’ foreign operation.
4. Paragraph 42 of IAS 21 states only that the results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy are to be translated into a different presentation currency as follows:
    a. all amounts (i.e. assets, liabilities, equity items, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent statement of financial position, except that
    b. when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (i.e. not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).
5. ESMA has identified the following issues where divergent application have been observed:
    a. Presentation of the combined effects of hyperinflation and foreign currency translation (FCT) of the results and financial position of a foreign operation whose functional currency is the currency of a hyperinflationary economy into the non-hyperinflationary presentation currency of its parent (‘Issue 1’), which on the basis of the existing Standards could be either:
        i. Separate presentation of hyperinflationary effect directly in equity and FCT effect as a separate component of other OCI (View 1)

[2] As well as parent’s functional currency

ii. Combined presentation of hyperinflationary effect and FCT effect directly in equity (View 2)

iii. Combined presentation of hyperinflationary effect and FCT effect as separate components of OCI (View 3).

b. [If View 2 of Issue 1 is applied] Possibility to reclassify to equity and change the presentation in the consolidated financial statements of the FCT adjustment (FCTA) amount accumulated in OCI before the entity became hyperinflationary upon the initial application of hyperinflationary accounting by the foreign operation ('Issue 2').

c. [If Views 1 or 2 of Issue 1 are applied] Applicability of the guidance in the paragraph 42(b) of IAS 21 upon initial application of hyperinflationary accounting of the foreign operation and the consistency of this guidance with the rationale of IFRIC 7 *Applying the Restatement Approach under IAS 29* that considers the restatement approach in IAS 29 akin to the retrospective application of a change in accounting policy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* ('Issue 3').

d. Finally, as for IFRS purposes Argentina was declared hyperinflationary as of 1 July 2018, application of paragraph 42(b) of IAS 21 as which is the presentation of FCTA amounts accumulated in the OCI in the 2019 interim consolidated financial statements with regards to the comparative information ('Issue 3A').

Issue 1: Presentation of hyperinflationary effect and FCTA effect

6. If the presentation currency of the group is a non-hyperinflationary currency, application of paragraphs 42 and 43 of IAS 21 implies that, first the adjustments of non-monetary assets and liabilities as well as equity balances of the foreign operation for hyperinflation are determined in accordance with IAS 29. Subsequently, further changes arise upon translation of all restated amounts of the foreign operation to the closing rate in order to be presented in the group consolidated accounts in accordance with IAS 21.

7. Whilst economic theory acknowledges the economic interrelationship between changes in the inflation and exchange rates, neither IAS 21 nor IAS 29 are clear on how such changes should be presented in these circumstances. ESMA observed the following accounting policies developed in accordance with paragraph 10 of IAS 8 and their rationales:

View 1: Separate presentation of hyperinflationary effect and FCT effect

8. Proponents of View 1 suggest, with reference to paragraph 25 of IAS 29, that the component reflecting the changes in the price level under IAS 29 should be presented as a direct adjustment to equity in the consolidated statement of changes in equity. At the same time, the component arising from changes in the foreign exchange rate used for translation are to be presented in OCI and thus accumulated in a separate component of equity and subsequently recycled to profit or loss in accordance with IAS 21.

9. For proponents of View 1, the changes in equity arise on retranslation of the financial statements of a foreign operation and thus should be presented in the same way as for a foreign operation whose functional currency is not hyperinflationary (referring to paragraph 39(c) of IAS 21).

10. While proponents of View 1 acknowledge the economic interrelationship between the hyperinflationary effect and the FCTA effect, they are of the view that because of their nature and the different accounting guidance in IAS 21 and IAS 29, these effects should be presented separately. Accordingly, in their view, the IAS 29 restatement approach does not override the general approach of IAS 21, which leads to the recycling of the accumulated FCTA reserve upon disposal of the foreign operation.

View 2: Combined presentation directly in equity

11. Proponents of View 2 argue that because of the economic interrelationship between the changes in the exchange rate and inflation, the hyperinflation and FCT effects should be presented together.
12. Furthermore, they argue that the combined effects of the changes in equity result from changes in the measuring unit applied to the net investment in the foreign operation. Considering the guidance in paragraph 25 of IAS 29, such changes do not give rise to gains and losses, but instead are to be treated as adjustments to the respective balances of equity (i.e. in the statement of changes of equity) without recycling.

View 3: Combined presentation in OCI

13. Proponents of View 3 argue that the entire amount should be presented in OCI and accumulated in a separate component of equity. They argue that the entire amount in substance represents retranslation of financial statements of a foreign operation to the group presentation currency. Accordingly, the guidance in paragraph 39(c) of IAS 21 applies for the entire amount, including its subsequent recycling upon disposal of the foreign operation.

Issue 2: Presentation of pre-hyperinflation FCTA reserve

14. In case View 2 of Issue 1 is applied, a further question arises about the treatment of the accumulated pre-hyperinflation FCTA reserve that was recorded previously in OCI and accumulated in a specific component of equity in accordance with paragraph 39(c) of IAS 21[3] and should be recycled upon disposal of the foreign operation.

View 1: Frozen FCTA reserve

15. Proponents of View 1 are of the opinion that the pre-hyperinflation FCTA previously recorded in OCI and accumulated in a specific component of equity should be frozen in accumulated OCI upon initial application of IAS 29 by the foreign operation so that it can be recycled upon disposal.
16. This corresponds to a literal reading of the paragraph 39(c) of IAS 21, i.e. no specific requirement of IAS 21 or IAS 29 overrides this requirement applicable for a situation when the currency of the foreign operation is the currency of a non-hyperinflationary economy.

[3] Paragraph 39(c) of IAS 21 requires accumulation in OCI of all foreign exchange differences on translation of a foreign operation denominated in a **non-hyperinflationary functional currency** (emphasis added).

17. The rationale for this view could be supported by the intention of the IASB expressed in paragraph BC22 of IAS 21 for why the Board decided not to require subsequent restatement of comparative amounts being translated into a presentation currency of a non-hyperinflationary economy. It explains why the Board developed a specific approach for the translation of comparatives for an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are translated into a presentation currency of a non-hyperinflationary economy.

18. While BC 22 of IAS 21 does not explicitly address the approach to be taken on first application of IAS 29 by the foreign operation in the consolidated financial statements, proponents of view 1 argue that this rationale equally applies. However, in light of the lack of specific guidance on the subsequent treatment of the FCTA, doubts have been expressed about whether this is the only acceptable view as well as its enforceability.

View 2: Reclassification of the accumulated FCTA reserve directly to equity

19. Proponents of View 2 highlight that IAS 21 does not provide sufficient guidance on the accounting implications on the already accumulated FCTA reserve related to the translation of the foreign operation that has become hyperinflationary. In particular, when the entity has made the accounting policy choice to present both FCTA effect and hyperinflationary effect of hyperinflationary foreign operation in equity (see Issue 1), proponents of View 2 argue that a retrospective application of this accounting policy on the subsequent presentation of the FCTA reserve directly in equity can be justified.

20. Paragraph BC17 of IFRIC 7 states that: '[…] *The IFRIC concluded that the opening balance sheet for the reporting period in which an entity identifies the existence of hyperinflation ought to be restated as if the entity had always applied the restatement approach under IAS 29. The IFRIC reconfirmed its view that this treatment is similar to the retrospective application of a change in accounting policy described in IAS 8*'.

21. In addition paragraph 24 of IAS 29 states that: '[…] *at the beginning of the first period of application of the Standard, the components of owners' equity, except retained earnings and any revaluation surplus, are restated […] any revaluation surplus that arose in previous periods is eliminated. Restated retained earnings are derived from all other amounts in the restated statements of financial position.'* Consequently, the first application of IAS 29 generates an overall restatement of the opening financial statements' equity components of the foreign operation whose functional currency becomes hyperinflationary during the financial year. Proponents of view 2 argue that such restatement is relevant also in the group financial statements even though the comparatives are subsequently not restated.

22. While the entity first applies the guidance in IAS 29 for restating the financial statements of the foreign operation to reflect the effect of inflation, and subsequently translates such restated financial statements to the presentation currency using the procedures in IAS 21, proponents of View 2 argue that in light of the lack of specific guidance in IAS 21 for reflecting first-time adoption of the hyperinflationary accounting in the consolidated financial statements, the rationale in paragraph BC17 of IFRIC 7 could be used in these circumstances. Consequently, any pre-hyperinflation FCTA reserve of the foreign operation, accumulated in a separate component of equity, could be reclassified within equity, without recycling, on initial application of IAS 29.

23. Proponents of View 2 also argue that a possible reading of paragraph 42(b) of IAS 21 that limits the application of the guidance in this paragraph only to subsequent (rather than first-time) application of IAS 29 restatement approach could support this logic ('Issue 3').

Issue 3: Application of guidance in paragraph 42(b) of IAS 21 on initial application of hyperinflationary accounting by the foreign operation

24. ESMA also observed divergent views on the application of paragraph 42(b) of IAS 21 upon initial application of the hyperinflationary accounting. While different reading of paragraphs 42(b) of IAS 21 has an impact on Issue 2 above, it also has repercussions on the presentation of other prior year balances in the consolidated financial statements of the group in the period of the first-time application of IAS 29 by the foreign operations.

25. Paragraph 42(b) of IAS 21 states that, when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the prior year financial statements. However, the brackets of that paragraph '(i.e. not adjusted for subsequent changes in the price level or subsequent changes in exchange rates)' could be read as limiting this guidance to the subsequent application of the hyperinflation accounting rather than its first application. This reading would be consistent with the rationale of IFRS IC in paragraph BC17 of IFRIC 7 (View 1).

26. However, this reading would seem to go against the intention of the IASB expressed in paragraph BC22 of IAS 21, which explains why the Board developed a specific approach for the translation of comparatives for an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are translated into a presentation currency of a non-hyperinflationary economy (View 2).

27. Paragraph BC16 of IFRIC 7 states that *'[…] for the purpose of presenting comparative amounts in a different presentation currency under IFRSs paragraphs 42(b) and 43 of IAS 21 apply. In such instances, an entity will have relief from the required restatement of comparatives under IAS 29*'. However, neither paragraph 42(b) of IAS 21 nor its rationale seem to provide explicit clarity on first-time adoption of the hyperinflationary accounting approach. While ESMA favors a teleological reading of paragraph 42(b) of IAS 21 in light of the purpose reflected in paragraph BC22 of IAS 21, ESMA is of the view that such reading should be confirmed by the IFRS IC.

Issue 3A: Specific implications for Interim financial statements

28. Finally, specifically for the situation in Argentina that became hyperinflationary on 1 July 2018, ESMA also notes that the answer to Issue 3 will have repercussions on the presentation of the comparative amounts in Q1 and Q2 2019 interim consolidated financial statements. ESMA notes different views expressed on this issue (Issue 3A), either to restate (View 1) or not to restate (View 2) these comparative amounts.

29. Proponents of View 1 argue that paragraph 42(b) of IAS 21 refers to relevant prior year financial statements (and not interim financial statements). Consequently, taking into account that IAS 29 was applied since the start of the annual reporting period (i.e. 1 January 2018), it might provide more comparable and relevant information to restate the amounts previously published for Q1 and Q2 2018 periods.

30. On the other hand, proponents of view 2 argue that if the issuer does not restate comparatives under IAS 29 when preparing the 2018 annual financial statements, this criteria should be applied consistently and comparatives amounts in Q1 and Q2 2019 interim financial statements should not be restated, because in Q1 and Q2 2018, the Argentinian economy was not yet considered as hyperinflationary.

Request

31. ESMA seeks clarification on following issues in the consolidated financial statements:

    a. The scope of application of paragraph 42(b) of IAS 21 in the first period when the foreign operation has become hyperinflationary and its interaction with paragraph BC17 of IFRIC 7. This including presentation of comparative amounts in Q1 and Q2 2019 interim financial statements;

    b. The presentation of the combined effects of hyperinflation and of foreign currency translation of a foreign operation whose functional currency is the currency of a hyperinflationary economy to a different presentation currency; and

    c. The accounting treatment of the FCTA reserve previously accumulated in a separate component of equity related to a foreign operation whose functional currency has become hyperinflationary, upon first-time application of hyperinflationary accounting by the foreign operation.

32. ESMA observes that different views have been expressed on these issues, leading to significant differences in the observed accounting treatments. ESMA notes that the effects of the diversity in application is material, in light of the significant amounts previously accumulated in the FCTA reserves, that might or might not be recycled, notably given the fact that an economy of a G20 member country has become hyperinflationary.