# HKFRS / IFRS UPDATE 2023/07

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## AMENDMENTS TO HKAS/IAS 21 – LACK OF EXCHANGEABILITY

### STATUS

Final Amendments

### EFFECTIVE DATE

1 January 2025.

### ACCOUNTING IMPACT

The Amendments introduce requirements to assess when a currency is exchangeable into another currency and when it is not. The Amendments require an entity to estimate the spot exchange rate when it concludes that a currency is not exchangeable into another currency.

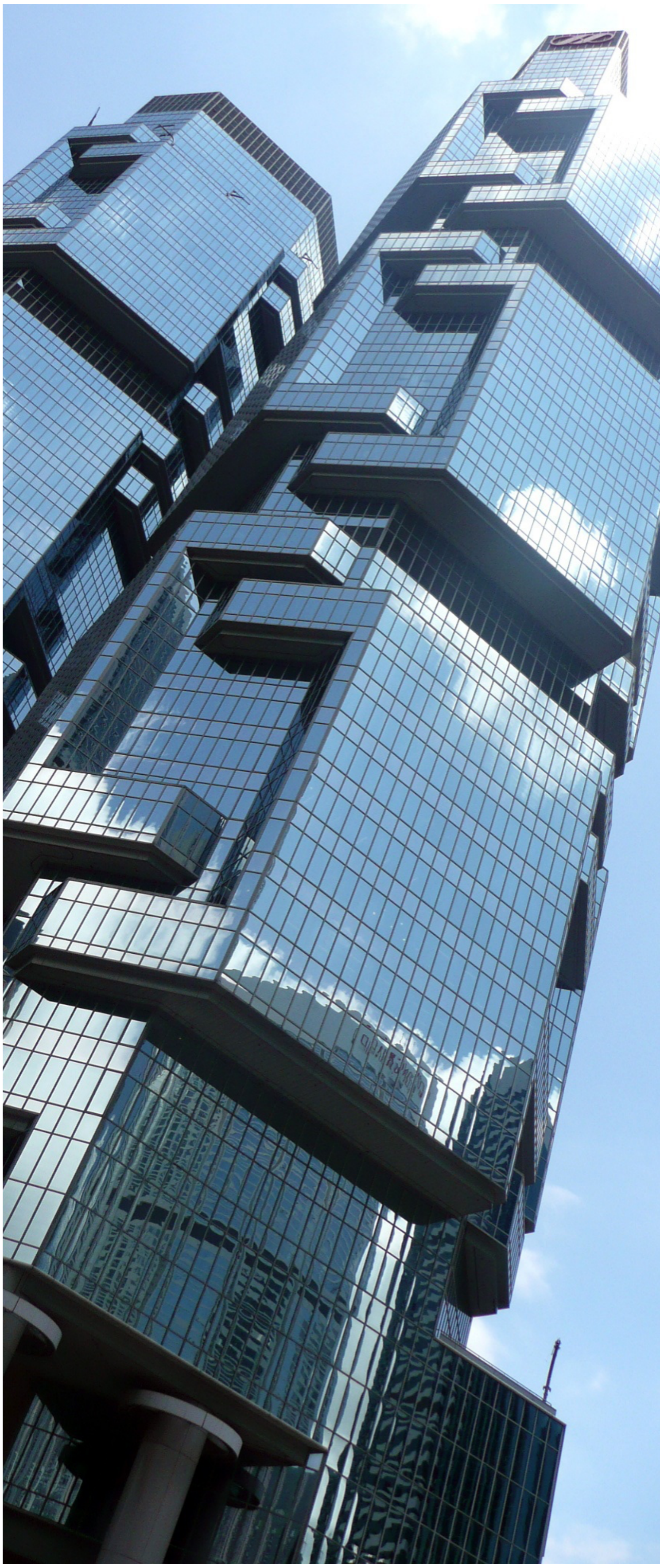
### BACKGROUND

On 15 August 2023, the International Accounting Standards Board (IASB) issued *Lack of Exchangeability* which amended IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

The amendments to IAS 21 arose as a result of a submission received by the IFRS Interpretations Committee (the Committee) about the determination of the exchange rate when there is a long-term lack of exchangeability. IAS 21, prior to the amendments, did not include explicit requirements for the determination of the exchange rate when a currency is not exchangeable into another currency, which led to diversity in practice. The Committee recommended that the IASB develop narrow-scope amendments to IAS 21 to address this issue. After further deliberations, the IASB issued an exposure draft of the proposed amendments to IAS 21 in April 2021 and the final amendments were issued in August 2023. The HKICPA published the equivalent amendments to HKAS 21 on 25 September 2023 (the Amendments).

The Amendments primarily include the following:

- Requirements to assess when a currency is exchangeable into another currency and when it is not
- Requirements to estimate the spot exchange rate when a currency is not exchangeable into another currency
- Additional disclosure requirements when an entity estimates the spot exchange rate because a currency is not exchangeable into another currency
- Application guidance to help entities assess whether a currency is exchangeable into another currency and to estimate the spot exchange rate when a currency is not exchangeable
- Illustrative examples
- Amendments to HKFRS/IFRS 1 *First-time Adoption of International Financial Reporting Standards* to align the requirements related to severe hyperinflation to the amended HKAS/IAS 21.



**Which entities will be affected by the Amendments?**

The following entities will be affected by the Amendments:

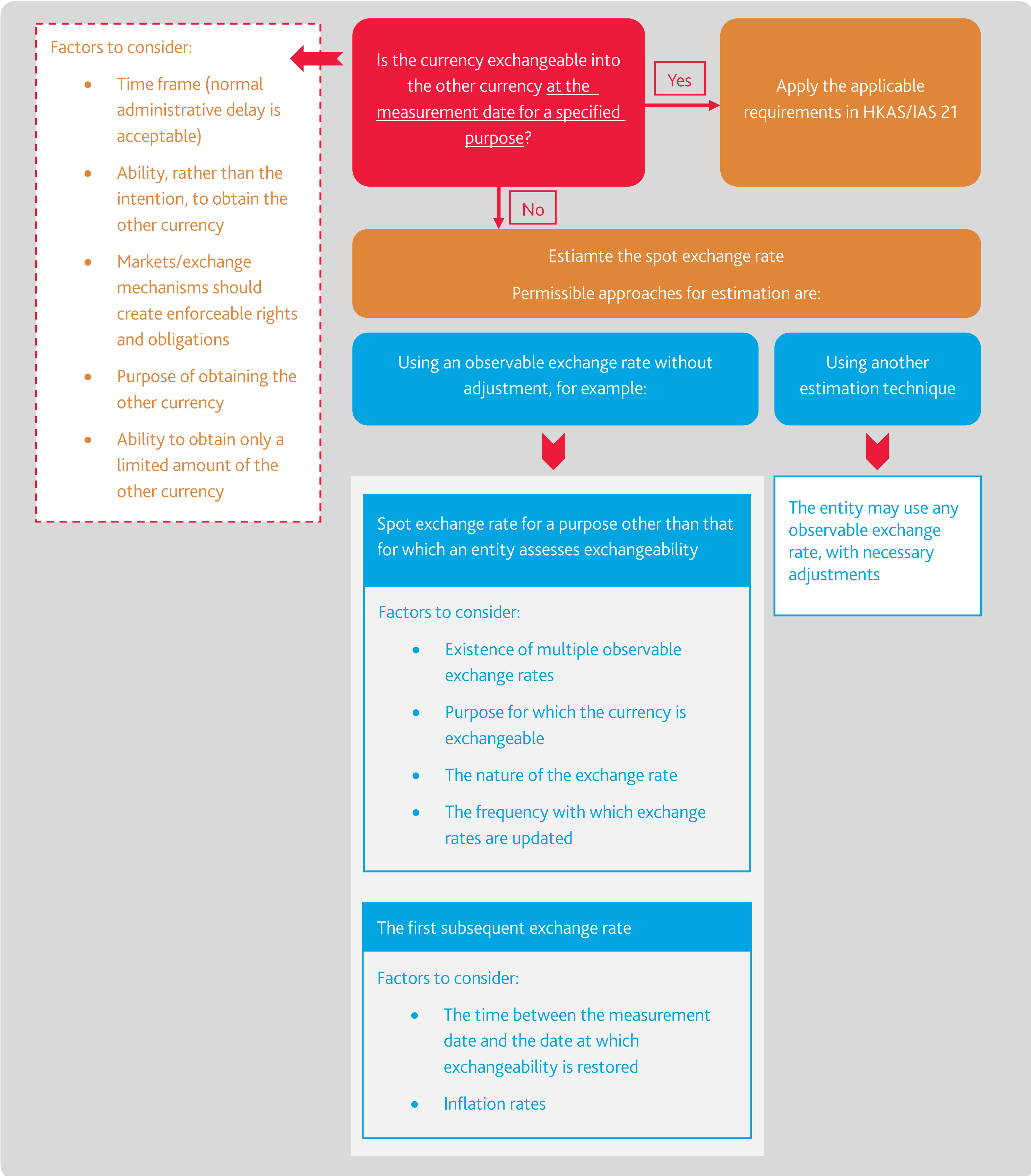
- An entity that enters into foreign currency transactions, which are required to be translated into its functional currency and
  - the entity's functional currency is not exchangeable into the foreign currency; or
  - the foreign currency is not exchangeable into the entity's functional currency
- An entity uses a presentation currency other than its functional currency and
  - the presentation currency is not exchangeable into the entity's functional currency; or
  - the entity's functional currency is not exchangeable into the presentation currency
- An entity translates the results and financial position of a foreign operation and
  - the foreign operation's functional currency is not exchangeable into the entity's presentation currency; or
  - the entity's presentation currency is not exchangeable into the foreign operation's functional currency.

## THE AMENDMENTS

The Amendments essentially introduce requirements for two steps:

1. Assessing whether a currency is exchangeable
2. Estimating the spot exchange rate when a currency is not exchangeable.

The following diagram summarises the requirements of the Amendments, which are further elaborated in the subsequent sections:



Meaning of 'exchangeable'

HKAS/IAS 21.8 (emphasis added)

*A currency is **exchangeable** into another currency when an entity is able to obtain the other currency within **a time frame that allows for a normal administrative delay** and through a **market or exchange mechanism** in which an exchange transaction would create **enforceable rights and obligations**.*

The Amendments further clarify that the exchangeability of a currency is assessed:

A. at a measurement date; and

B. for a specified purpose (HKAS/IAS 21.8A).

*When is a currency not exchangeable into another currency?*

The Amendments clarify that a currency is not exchangeable into another currency if an entity is able to obtain ***no more than an insignificant amount of the other currency at the measurement date*** for the ***specified purpose*** (HKAS/IAS 21.8B).

It should be noted that a currency may not be exchangeable into another currency, even though the other currency is exchangeable in the given currency.

Key points to note and factors to consider while assessing exchangeability of a currency include:

- Time frame:

  A normal administrative delay in obtaining the other currency does not preclude a currency from being exchangeable into that other currency.

- Ability, rather than the intention, to obtain the other currency:

  An entity is required to consider its ability to obtain the other currency, rather than its intention or decision to do so, when assessing exchangeability of the currency.

- Markets or exchange mechanisms:

  In assessing exchangeability of a currency, an entity is required to consider only markets or exchange mechanisms in which a transaction to exchange the currency for the other currency would create enforceable rights and obligations.

- Purpose of obtaining the other currency:

  There may be different exchange rates applicable for different uses of a currency. A currency may be exchangeable into another currency for some purposes, but not for some others. In assessing exchangeability, depending on the nature of the transaction, the entity is required to assume its purpose in obtaining the other currency as below:

| Transaction | Purpose in obtaining the other currency |
|---|---|
| Reporting foreign currency transactions in the entity's functional currency | To realise or settle individual foreign currency transactions, assets or liabilities |
| Translation to a presentation currency other than the entity's functional currency | To realise or settle individual foreign currency transactions, assets or liabilities |
| Translation of the results and financial position of a foreign operation into the presentation currency | To realise or settle its net investment in the foreign operation |

  An entity is required to assess exchangeability of a currency into another currency separately for each purpose.

- Ability to obtain only limited amounts of the other currency:

  A currency is not exchangeable into another currency if, for a specified purpose, an entity is able to obtain no more than an insignificant amount of the other currency. The significance of the amount of the other currency the entity is able to obtain for a specified purpose is assessed by comparing that amount with the total amount of the other currency required for that purpose.

For example, Entity A's functional currency is LC. Entity A has long-term foreign currency borrowings in currency FC. Entity A also has trade payables denominated in currency FC incurred relating to the import of electronic goods. As at 31 December 20X1, the carrying amounts of Entity A's liabilities denominated in currency FC are as below:

- foreign currency borrowing: FC1,000,000
- trade payables: FC10,000 (total imports during the year: FC70,000).

The relevant authority in Entity A's jurisdiction allows entities to obtain currency FC for the import of electronic goods up to FC100,000 in one year. Entities are allowed to obtain currency FC for repayment of long-term borrowings only up to FC50,000 in one year.

Entity A is required to assess exchangeability of currency FC separately for translation of foreign currency borrowings and foreign currency trade payables.

Entity A may assess that it is able to obtain sufficient amount of currency FC to settle its trade payables, as the amount of currency FC required conserving its imports during the year 20X1 is within the annual limits set by the relevant authority. However, it may assess that it is able to obtain no more than an insignificant amount of currency FC to settle the long-term borrowings, as it is able to obtain only FC50,000 against its liability of FC1,000,000. Therefore, Entity A will be required to apply the Amendments to estimate the spot exchange rate as at 31 December 20X1 for translating the long-term foreign currency borrowing into its functional currency LC. The balance of trade payables will be translated into currency FC applying the other requirements of HKAS/IAS 21. It should be noted that a currency may not be exchangeable into another currency, even though the other currency is exchangeable in the given currency.

**Estimating the spot exchange rate when a currency is not exchangeable into another**

When a currency is not exchangeable into another currency at a measurement date for a specified purpose, the Amendments require the entity to estimate the spot exchange rate at the measurement date (HKAS/IAS 21.19A).

Newly inserted paragraph 19A specifies the objective in estimating the spot exchange rate as below (**emphasis added**):

'…. *An entity's objective in estimating the spot exchange rate is to reflect the rate at which an* ***orderly exchange transaction*** *would take place* ***at the measurement date*** *between* ***market participants*** *under* ***prevailing economic conditions****.*'

The Amendments do not specify how an entity estimates the spot exchange rate to meet the objective in HKAS/IAS 21.19A. The application guidance specifies that an entity can use an observable exchange rate without adjustment or another estimation technique.

A. **An observable exchange rate without adjustment:**

Examples of an observable exchange rate include:

a) A spot exchange rate for a purpose other than that for which an entity assesses exchangeability:

If a currency that is not exchangeable into another currency for one purpose is exchangeable into that currency for another purpose and if the entity concludes that the observable exchange rate for the other purpose meets the objective in HKAS/IAS 21.19A, an entity may use that rate as the estimated spot exchange rate.

The factors to be considered in this assessment include the following:

- Existence of multiple observable exchange rates:
  Existence of multiple exchange rates may be indicative of 'incentive' or 'penalty' included in the rate in order to incentivise or deter the use of the other currency for particular purposes. Such rates might not reflect the prevailing economic conditions.
- Purpose for which the currency is exchangeable:
  If an entity is able to obtain the other currency only for limited purposes, the observable exchange rate might not reflect the prevailing economic conditions.
- The nature of the exchange rate:
  A free-floating observable exchange rate is more likely to reflect the prevailing economic conditions than an exchange rate set through regular interventions by the relevant authorities.
- The frequency with which the exchange rates are updated:
  An observable exchange rate unchanged over time is less likely to reflect the prevailing economic conditions than an observable exchange rate that is updated on a daily basis (or even more frequently).

b) <u>The first subsequent exchange rate:</u>

A currency that is not exchangeable into another currency at the measurement date for a specified purpose might subsequently become exchangeable into that currency for that purpose. An entity may use such rate (the first subsequent exchange rate) as the estimated spot exchange rate if it concludes that the rate meets the objective in HKAS/IAS 21.19A. The factors to be considered in this assessment include the following:

- The time between the measurement date and the date at which exchangeability is restored:
  The shorter the time between the measurement date and the date at which exchangeability is restored, the more likely the first subsequent exchange rate will reflect the prevailing economic conditions.

- Inflation rates:
  For economies subject to high inflation, including when an economy is hyperinflationary, the first subsequent exchange rate for a currency of such an economy might not reflect the prevailing economic conditions.

**B. <u>Another estimation technique</u>**

An entity is permitted to use another estimation technique to estimate the spot exchange rate. In such estimation techniques, the entity is permitted to use any observable exchange rate, including rates from exchange transactions in markets or exchange mechanisms that do not create enforceable rights and obligations, and adjust that rate, as necessary, to meet the objective in HKAS/IAS 21.19A.

In jurisdictions with long-term lack of exchangeability, there may be markets or exchange mechanisms that do not create enforceable rights and obligations (eg. unofficial trading of foreign currency).

For the purpose of assessing whether a currency is exchangeable, entities are not permitted to consider availability of the currency in such markets or exchange mechanisms. However, once an entity concludes that the currency is not exchangeable at a measurement date and for a particular purpose, the entity is required to estimate the spot exchange rate at the measurement date and for the specified purpose. For such estimation, the entity is permitted to use an observable exchange rate from exchange transactions in markets or exchange mechanisms that do not create enforceable rights and obligations, with necessary adjustments.

### Disclosure requirements

The Amendments introduce additional disclosure requirements when an entity estimates a spot exchange rate because a currency is not exchangeable into another currency.

The disclosure objective of the new disclosure requirements is '*to enable users of its financial statements to understand how the currency not being exchangeable into the other currency affects, or is expected to affect, the entity's financial performance, financial position and cash flows*' (HKAS/IAS 21.57A).

To achieve this objective, an entity is required to disclose information about:

- The nature and financial effects of the currency not being exchangeable into the other currency
- The spot exchange rate(s) used
- The estimation process
- The risks to which the entity is exposed because of the currency not being exchangeable into the other currency.

## EFFECTIVE DATE AND TRANSITION

An entity shall apply the Amendments for annual reporting periods beginning on or after 1 January 2025 with earlier application permitted.

The date of initial application is the beginning of the annual reporting period in which an entity first applies those amendments.

In applying the Amendments, an entity is not permitted to restate comparative information. The Amendments require the following with respect to the accounting at the date of initial application:

| | Purpose of applying the Amendments | Translation of the affected balances at the date of initial application | Effect of initially applying the Amendments |
|---|---|---|---|
| (a) | *Reporting foreign currency transactions in the entity's functional currency:*<br>At the date of initial application<br>• the entity's functional currency is not exchangeable into the foreign currency; or<br>• the foreign currency is not exchangeable into the entity's functional currency. | Translate affected foreign currency monetary items, and non-monetary items measured at fair value in a foreign currency, using the estimated spot exchange rate at the date of initial application. | Recognised as an adjustment to the opening balance of retained earnings. |
| (b) | *Using a presentation currency other than the entity's functional currency or translating the results and financial position of a foreign operation:*<br>At the date of initial application:<br>• the entity's functional currency (or the foreign operation's functional currency) is not exchangeable into its presentation currency; or<br>• the entity's presentation currency is not exchangeable into its functional currency (or the foreign operation's functional currency). | Translate affected assets and liabilities using the estimated spot exchange rate at the date of initial application.<br>*If the entity's functional currency is hyperinflationary:*<br>Translate affected equity items using the estimated spot exchange rate at the date of initial application. | Recognised as an adjustment to the cumulative amount of translation differences - accumulated in a separate component of equity. |

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