



Foreign Currency Accounting

24 November 2011

***Presented by FX Research Team
Korea Accounting Standards Board***

The views expressed in this presentation are those of the FX research team of KASB, not necessarily those of the KASB

Background

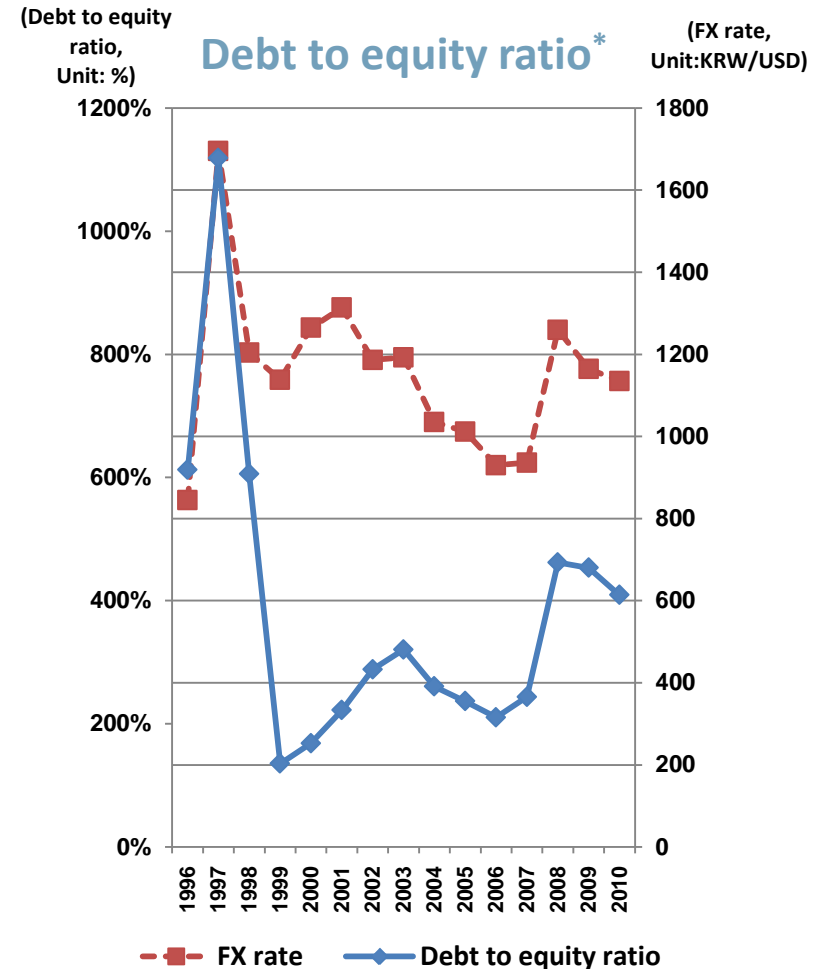
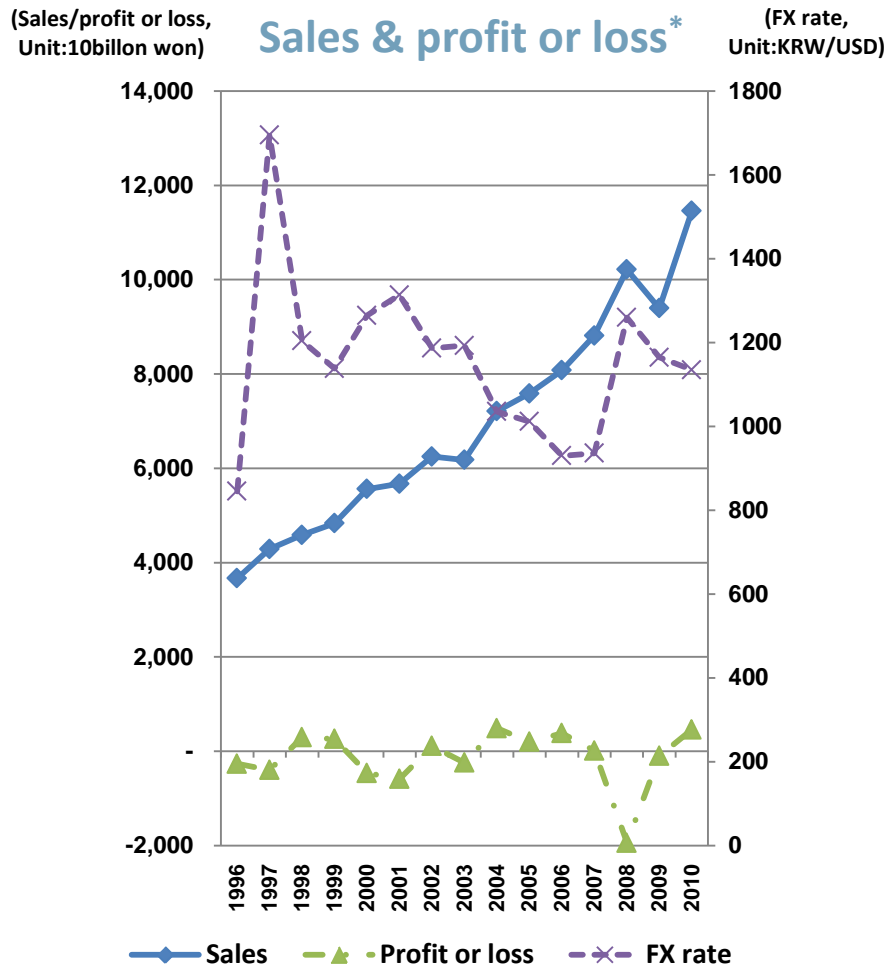
- **Recurring requests from entities in emerging economies**
- ✓ Translating foreign currency monetary items at **the closing rate** **might not** reflect the economic substance **in rare circumstances such as financial crises**
- ✓ **Exchange rates** that have significantly fluctuated during the financial crises **tend to recover** after a certain period of time

Paragraph 23 of IAS 21

- ✓ *At the end of each reporting period:*
 - (a) foreign currency monetary items shall be translated using the closing rate*

Background

- An example: A company**



Analogy with IAS 36

- **Market's best estimate**

BCZ46 IAS 36 indicates that value in use in a foreign currency is translated into the reporting currency using the spot exchange rate at the balance sheet date.

BCZ47 If a currency is freely convertible and traded in an active market, the spot rate reflects the **market's best estimate** of future events that will affect that currency. Therefore, the only available unbiased estimate of a future exchange rate is the current spot rate,



BCZ50 If a currency is **not freely convertible** or is **not traded in an active market**—with a consequence that it can no longer be assumed that the spot rate reflects the market's best estimate of future events

Analogy with IAS 19

- **Deep market**

78 The rate used to discount post-employment benefit obligation (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is **no deep market** in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.



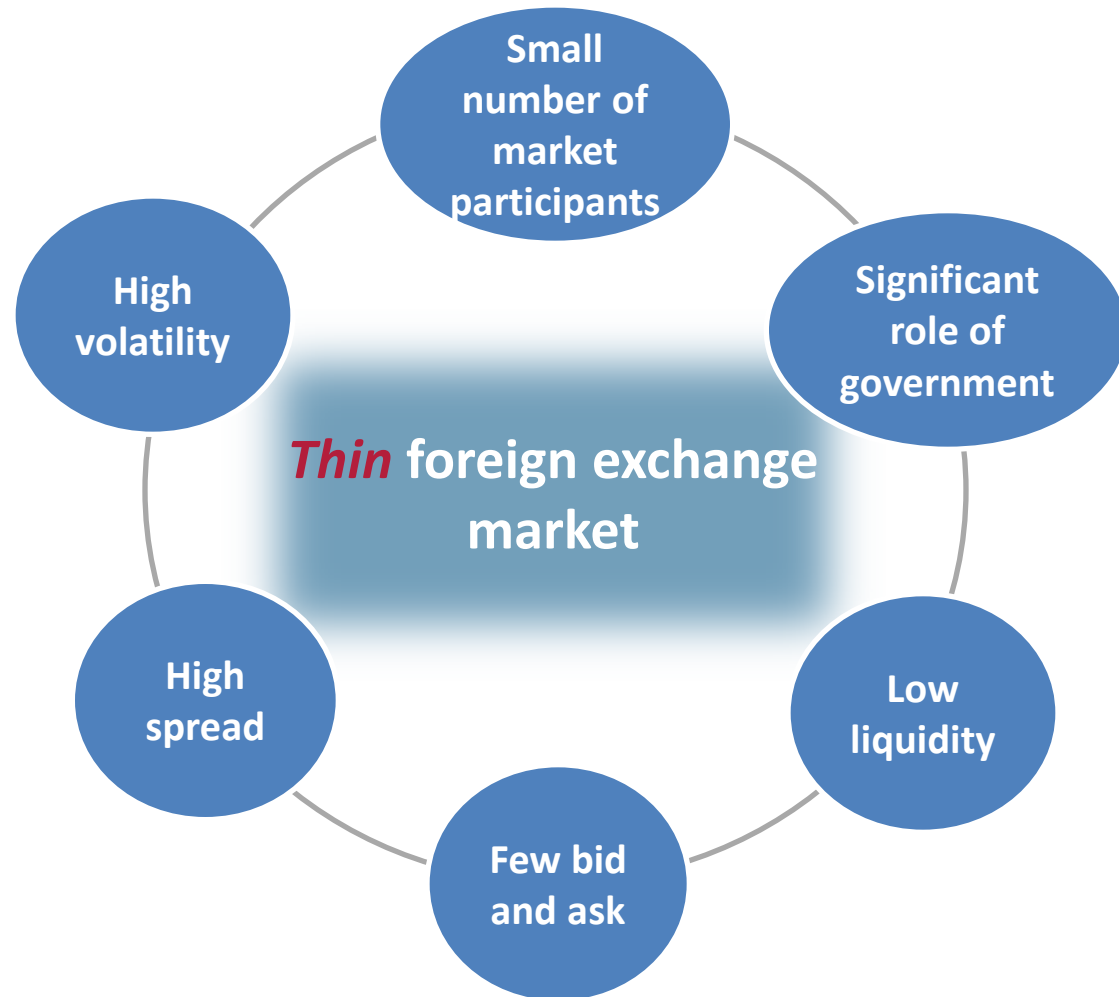
Our view

The return of corporate bonds in a market that is **not deep (i.e. thin) is unable to reflect the best estimate of the liability** at the time of settling post-employment benefit payables in the future.

Determining the scope of amendment

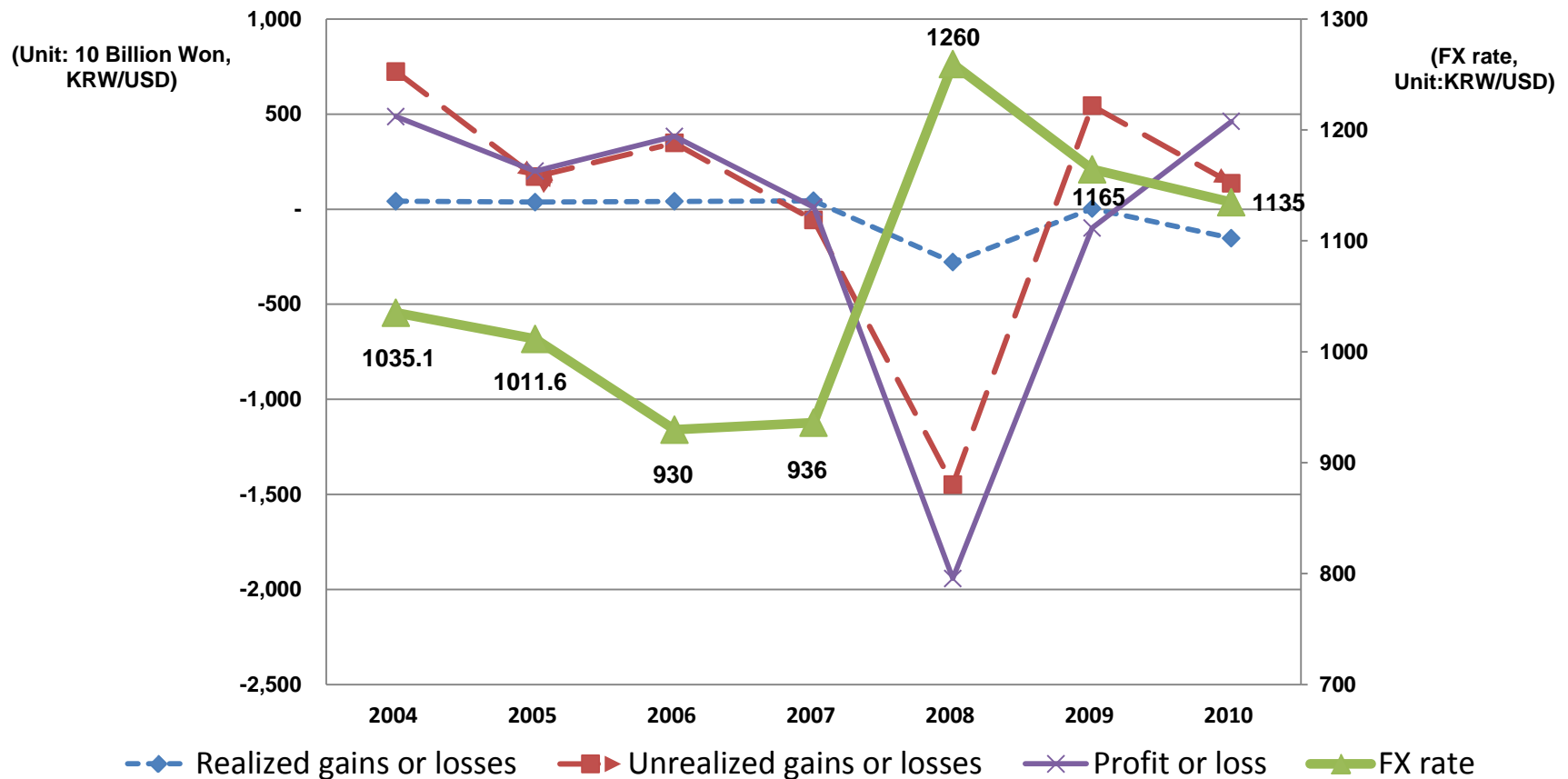
- *This extreme degree of foreign-exchange market thinness was an important factor that not only contributed to the crisis but is also constraining the ongoing adjustment to the crisis.*
[the World Bank, 1999]

- *If the market is thin and controlled by a small number of operators, free float will inevitably lead to a large degree of volatility.*
[Economic and Social Commission for Asia and the Pacific, 2002]



Determining the scope of amendment

Gains or losses related to foreign currency*



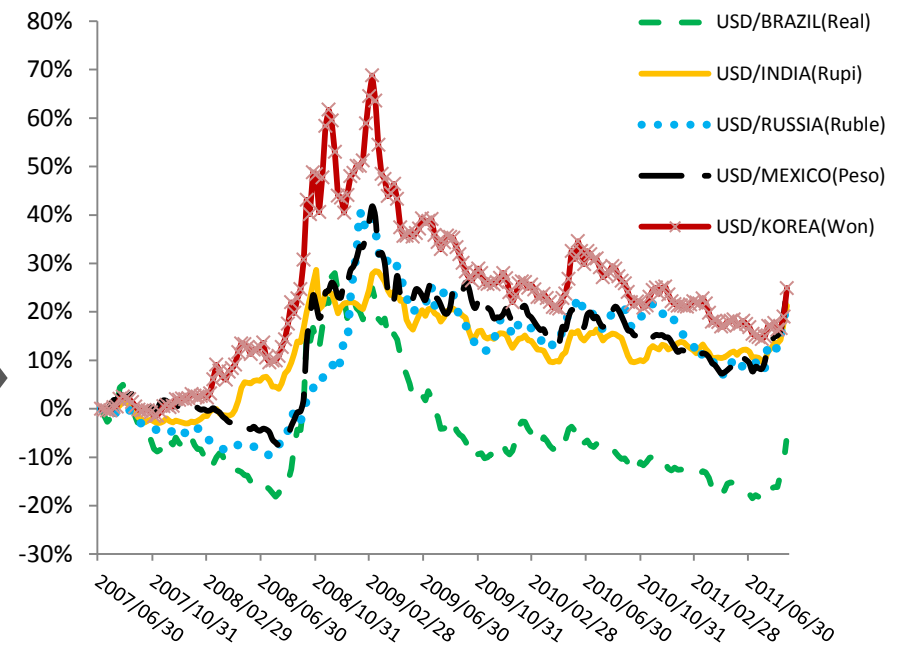
* The above graph is showing the gains or losses related to the translation of foreign currency transaction of A Co. between 2004 and 2010

Determining the scope of amendment

- The closing rate does not reflect the market's best estimate in rare circumstances

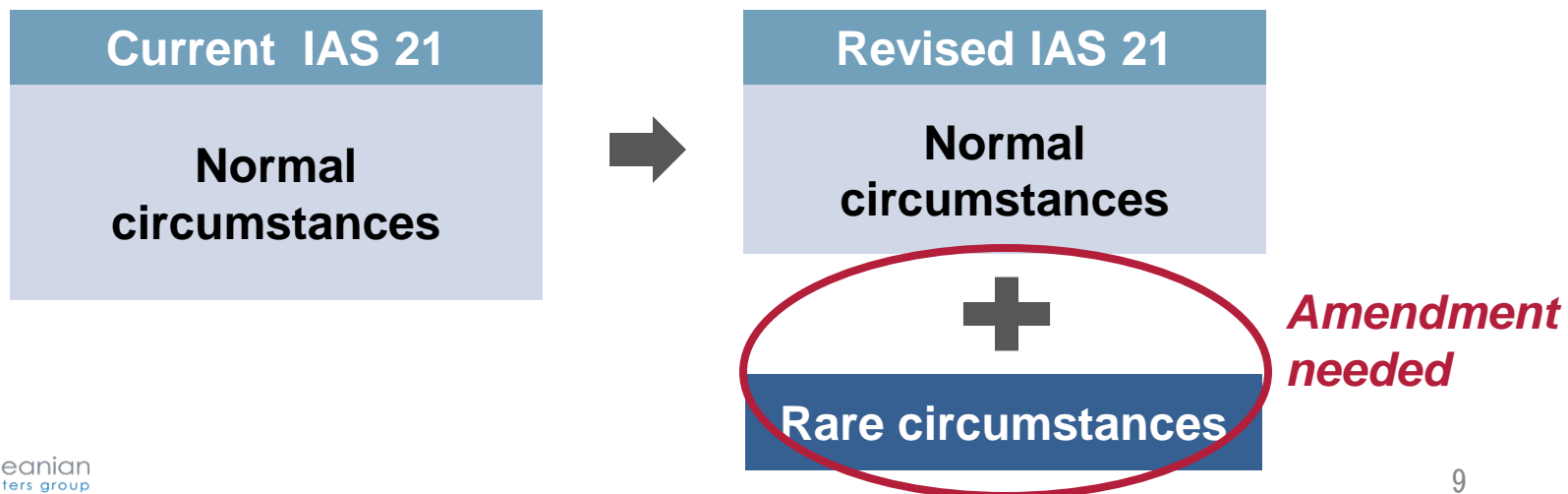


FX volatility in emerging economies



Determining the scope of amendment

- The **principle inherent in IAS 21** is to use the rate that reflects the **market's best estimate** of future events
- ✓ Using the closing rate cannot be the principle per se, but simply conforms to the principle in almost all cases
- This study focuses on **clarifying the principle** and **providing guidance on rare circumstances**



Determining the scope of amendment

- What rate is better than the closing rate?

	Market where the closing rate <u>does</u> represent the market's best estimate of future events (E.g. Deep market)	Market where the closing rate <u>does not</u> represent the market's best estimate of future events (E.g. Thin market)
Rare circumstances (e.g. financial crisis)	IAS 21 maintained	? (Long term item)
Normal circumstances	IAS 21 maintained	IAS 21 maintained ^(*)

Review required

(*) Although the closing rate does not represent the market's best estimate of future events, it is unlikely to obtain a more reliable rate than the closing rate; it is also in accord with Basis of conclusions in IAS 36

Summary

- **Add a requirement addressing rare circumstances** where the closing rate does not represent the best estimate
- **Limit rare circumstances** to where all of the following conditions are met:
 - i) Foreign exchange market classified as a **“thin market”**,
 - ii) Significant exchange rate fluctuation due to exceptional and **temporary external shocks including financial crises**, and
 - iii) **Long-term** foreign currency items
- **Apply alternative rates** that better represent the economic substance than the closing rate in the above circumstance

Proposal

- **Suggested alternative rates** to use in rare circumstances where the closing rate does not represent the best estimate

	Alternative 1	Alternative 2
Model	▪ Adjusted historical rate model	▪ Expected rate model
How to calculate	▪ Use a long term trend line based on historical data	▪ Use the expected exchange rate that reflects the best estimate at the time of settlement of each long-term monetary item
Examples	<ul style="list-style-type: none"> ▪ A historical rate adjusted by the long-term trend line ▪ A moving average rate (e.g. 3-yr moving average rate without the closing rate or 5-yr moving average rate) 	<ul style="list-style-type: none"> ▪ An econometrically forecasted rate at the B/S date using macroeconomic variables ▪ A rate calculated by extending the long-term trend line to the expected settlement date of each long-term item

To be discussed further

- In-depth **study on the microstructure of foreign exchange market** from the perspective of economics
- Develop concrete **indicators of determining a “thin market”**
- Further research as to what **characteristics are required of alternative exchange rates** to replace the closing rate

Future Plans

- **Request for adoption as an IASB post-2011 agenda**
 - ✓ Adoption as an official IASB project
 - ✓ With full support from IASB, further research will be effective
- **Cooperation with countries having the same problems**
 - ✓ Active discussion among constituents for alternative accounting treatments

Thank you!