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Foreign currency exchange accounting implications of recent government actions in Venezuela.

This IFRS Alert provides an update on potential accounting implications as a result of recent actions taken by the Venezuelan government ("the government") regarding foreign currency exchange controls.

In accordance with Venezuelan foreign currency exchange control regulations ("exchange regulations" or "regulations"), the Central Bank of Venezuela (BCV) centralizes the purchase and sale of foreign currency in the country through the Commission for the Administration of Foreign Exchange (CADIVI). Additionally, under these regulations, the purchase and sale of foreign currency must be made at one of two "official" rates of exchange: (1) "the essentials rate" at BsF[1] 2.60 per U.S. dollar and (2) "the nonessentials rate" at BsF 4.30 per U.S. dollar.

As originally enacted, the regulations imposed strict criminal and economic sanctions on the use of methods other than those officially designated for the exchange of Venezuelan currency with other currency. However, they exempted the purchase and sale of securities, including national public debt bonds (DPNs) denominated in BsF and bonds issued by the government denominated in U.S. dollars. This exemption for transactions in certain securities created an indirect "parallel" foreign currency exchange market in Venezuela that enabled entities to use brokers to obtain foreign currency without having to purchase the currency from the CADIVIat one of the official rates. The average rate of exchange in the parallel market varied but generally was higher than the official rates.

The government has publicly stated that it believes the parallel market has been a primary cause of Venezuela's continuing runaway inflation and, accordingly, in May 2010 it enacted reforms to its regulations to close down the parallel market. It declared that foreign-currency-denominated securities issued by Venezuelan entities, including the government, were included in the definition of foreign currency, thus making the BCV the only institution that could legally authorise the purchase or sale of foreign currency bonds thereby excluding non-authorised brokers from the foreign exchange market.

In June 2010, under a newly regulated exchange system (the SITME[2]) controlled by the BCV, the government introduced additional regulations, including a currency exchange trading band on the BsF free-floating exchange rate in an attempt to halt further inflation spikes. Entities domiciled in Venezuela can access the SITME by buying U.S. dollar-denominated securities through banks authorised by the BCV. The SITME imposes volume restrictions on an entity's trading activity, limiting such activity to a maximum equivalent of $50,000 per day, not to exceed $350,000 in a calendar month.

1 Bolivar fuertes

2 Sistema de Transacciones con Títulos en Moneda Extranjera (system of exchange for foreign-currency-denominated securities)

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This limitation is non-cumulative, hence an entity cannot carry over unused volume from one month to the next (e.g., if an entity obtains the U.S. dollar equivalent of $300,000 in one month, it will not be able to avail itself of a $400,000 equivalent in the following month).

The SITME began on June 9, 2010, with the BCV establishing a weighted average implicit exchange rate of approximately 5.3 BsF per U.S. dollar. The average daily volume of the SITME market since it opened has been approximately $28.5 million (total transaction volume as of 30 June 2010, was $398 million). Foreign exchange transactions not conducted through CADIVI (using one of the two official exchange rates) or SITME may not comply with the amended exchange regulations and could therefore be considered illegal.

These latest modifications to Venezuela's foreign exchange system raise a number of accounting concerns.

Remeasurement of foreign currency transactions

IAS 21 paragraph 26 states that "when several exchanges rate are available, the rate used is that at which the future cash flows represented by the transaction or balance should have been settled if those cash flows had occurred at the measurement date".

An entity may have previously concluded it was legally able to access the parallel market and therefore used the parallel rate to remeasure foreign currency transactions that occurred before the enactment of the amended exchange regulations, provided that the transactions met all applicable criteria for use of that rate. It is understood that after enactment of the amended exchange regulations (and cessation of the parallel market), the only foreign currency exchange processes legally available to entities operating in Venezuela are (1) exchange of currency, through the CADIVI, at one of the official rates for exchange or (2) exchange of currency, through the SITME, at the exchange rate specified by the BCV.

The use of an exchange rate created through an illegal market is not supported under IFRSs hence an entity should not use the parallel market rate to remeasure foreign currency transactions occurring after enactment of the amended exchange regulations where it concludes that use of the parallel market is in violation of the amended exchange regulations and therefore considered illegal. Entities should consult with their legal counsel accordingly, where use of the parallel market is considered illegal, entities should use one of the foreign currency exchange rate mechanisms that comply with the amended exchange regulations to remeasure foreign-currency-denominated transactions occurring after their enactment, selecting an appropriate rate on the basis of their relevant facts and circumstances. In determining which exchange rate to use, entities should consider the daily and monthly volume restrictions imposed by SITME described above. Furthermore, entities should assess carefully their ability to use one of the two official rates to settle transactions (e.g., dividends) when determining the appropriate rate to use.

Translation of Venezuelan Bolivars functional currency financial statements into a non-hyperinflationary presentation currency

When translating Venezuelan operations in the current period into the currency of a non-hyperinflationary economy IAS 21.42 (a) specifies that "all amounts (i.e. assets, liabilities, equity items, income and expenses…) shall be translated at the closing rate at the date of the most recent statement of financial position."

IAS 21 does not address specifically which exchange rate to use to translate financial statements into a presentation currency. IAS 21 paragraph 8 defines the closing rate as "the spot exchange rate at the end of the reporting period". The closing rate should be the rate an entity would pay or receive currently in the market. We believe that when translating financial statements the exchange rate at which the entity would be able to realise the net investment (e.g. dividend or sale) would be the appropriate rate.

As discussed above, entities that may have used the parallel exchange rate to translate Venezuelan financial statements may have to reconsider the appropriateness of continuing to use that rate if it is considered illegal as a result of the newly enacted regulations.

Similarly to when an entity determines the appropriate rate to use for remeasurement of foreign currency transactions, an entity should use judgement in determining which of the rates described above would be the most appropriate rate at which an entity believes it would be able to realise its net investment.

Consolidation considerations

As discussed above, the strict volume restrictions on exchange activity conducted through the SITME process, in conjunction with the uncertainties of obtaining approval for foreign exchange at one of the official rates, may cause an entity to question whether an 'other-than-temporary' lack of exchangeability exists for its Venezuelan operations. Entities should consider the guidance in IAS 21 paragraph 26, which states: "if exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made." Additionally, entities should carefully consider whether a lack of exchangeability results in the loss of control in accordance with IAS 27, paragraph 32.

The mere existence of such exchange restrictions does not in and of itself create a presumption that an entity has lost control and should cease to consolidate its Venezuelan operations, nor does the ability to exchange some volume of currency create a presumption that the entity continues to control and continued consolidation of Venezuelan operations is appropriate. An entity must make an assessment on the basis of its specific facts and circumstances. Even if an entity ultimately concludes that ceasing to consolidate is appropriate, it must still determine (1) the date from which to cease consolidation and (2) the appropriate exchange rates for translation of its associate interest (where significant influence is retained) or investment (where it has neither control or significant influence). Regardless of whether continued consolidation is considered appropriate or not, an entity should assess whether the severity of the foreign currency exchange controls represents a triggering event that would require an entity to assess its Venezuelan investments, tangible and intangible assets, and any other outstanding balances of its Venezuelan operations for impairment.

Similarly, entities that hold investments in Venezuelan operations accounted for as associates under IAS 28 or joint ventures under IAS 31, as well as entities holding Venezuelan debt or equity securities and loans or receivables not carried at fair value through profit or loss, should assess whether an impairment loss may exist as of the reporting date (e.g., June 30, 2010) resulting from the current operating and economic uncertainties in Venezuela.

Current/concurrent classifications

Entities should also consider whether classifying certain BsF-denominated monetary assets as current is still appropriate in light of the present economic environment in Venezuela, particularly if they encounter difficulties in converting such assets into another currency. This assessment will depend on an entity's facts and circumstances and its ability to obtain necessary approvals to convert such balances at an appropriate exchange rate and volume.

Necessity for robust disclosure

The recent actions taken by the government have created situations in which the accounting guidance is not entirely clear (e.g., determining the appropriate exchange rate to use for remeasurement) and may have a significant effect on the financial statements of certain reporting entities. Accordingly, it is critical that entities provide robust disclosure in the notes to the financial statements. Because of the complexity of these accounting and disclosure issues, we encourage entities with Venezuelan operations to consult with their accounting advisers and legal counsel.

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