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Venezuela's Currency Exchange Controls and Highly Inflationary Status

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This Financial Reporting Alert highlights foreign currency exchange controls in Venezuela and recent developments related to the classification of Venezuela's economy as highly inflationary. It also discusses issues that have arisen as a result of Venezuela becoming a highly inflationary economy as well as the recent devaluation of Venezuela's local currency. Entities with operations in Venezuela should be aware that these issues could affect their consolidated financial statements as of December 31, 2009. This alert will be updated in the future to reflect new developments as warranted.

Highly Inflationary Status

On January 7, 2010, Venezuela's National Consumer Price Index for December 2009 was released. The cumulative three-year inflation rates for both of Venezuela's inflation indices[1] are over 100 percent. ASC 830-10-45-12[2] (formerly Topic D-55[3]) states that the "determination of a highly inflationary economy must begin by calculating the cumulative inflation rate for the three years that **precede the beginning of the reporting period**" (emphasis added). Accordingly, entities with a year-end or quarter-end as of December 31, 2009, that have not previously considered Venezuela's economy to be highly inflationary, should consider Venezuela's economy to be highly inflationary as of January 1, 2010, and the financial statements of Venezuelan entities will need to be remeasured as if the functional currency were the reporting currency as of January 1, 2010.

ASC 830-10-45-11 (formerly paragraph 11 of Statement 52[4]) defines a highly inflationary economy as one with a cumulative inflation rate of approximately 100 percent or more over a three-year period. ASC 830-10-45-12 provides additional interpretative guidance on determining whether an economy is highly inflationary. Under ASC 830, if a country's economy is classified as highly inflationary, the functional currency of the foreign entity operating in that country must be remeasured to the functional currency of the reporting entity.

Historically, the IPTF[5] has monitored the highly inflationary status of certain countries and has specifically used the Consumer Price Index (CPI) to evaluate the inflationary status of the Venezuelan economy. The Venezuelan CPI has been tracked since 1984; however, until January 2008 it was only based on data for the cities of Caracas and Maracaibo. The use of a new index, the National Consumer Price Index (NCPI), which covers the entire country of Venezuela (i.e., a broad-based measure of inflation for the country as a whole), began on January 1, 2008. Inflation data is therefore not available for entities to compute a cumulative three-year inflation rate for the entire country solely on the basis of the NCPI. Instead, entities can calculate the cumulative three-year inflation rate on a blended basis by using CPI data for the periods before January 1, 2008, and NCPI data for the periods after January 1, 2008.

Alternatively, the three-year cumulative inflation rate can be calculated solely on the basis of the CPI data. The SEC staff has indicated in meetings with the IPTF that it would not object to either approach to computing the three-year cumulative inflation rate. However, the SEC staff believes that when the NCPI data is eventually

available for the three years ending December 31, 2010, and thereafter, only the NCPI should be used to assess the highly inflationary status of Venezuela because that index represents a broad-based measure of inflation for the entire country of Venezuela.

Once a country's economy is classified as highly inflationary, a decrease in the cumulative three-year rate below 100 percent does not necessarily mean that the country's economy is no longer highly inflationary. ASC 830-10-55-25 (formerly Example B of Topic D-55) describes a situation in which a country's economy should continue to be classified as highly inflationary because there is no evidence to suggest that a drop in the cumulative three-year rate below 100 percent is "other than temporary."

At the 2009 AICPA National Conference on Current SEC and PCAOB Developments (the "2009 AICPA Conference"), the SEC staff indicated that if the three-year cumulative rate of a highly inflationary economy decreases below 100 percent, an entity must consider whether the economy is no longer highly inflationary by using an other-than-temporary type of analysis. In particular, an entity should consider the length of time that the rate has been under 100 percent, the magnitude of the decrease below 100 percent, and the current economic conditions of the country.

Editor's Note: The guidance on foreign currency translation and highly inflationary economies under IFRSs differs significantly from that under U.S. GAAP. For example, among the many differences between accounting for highly inflationary economies under U.S. GAAP and IFRSs is the period in which an entity would consider the economy highly inflationary. Entities that apply IFRSs would apply the guidance in IAS 29[6] as of the **end** of the reporting period in which the economy is deemed highly inflationary. This Financial Reporting Alert focuses only on the ramifications for entities that apply U.S. GAAP; it does not discuss the differences between IFRSs and U.S. GAAP.

Foreign Currency Statements and Transactions

Background

Pursuant to certain Venezuelan foreign currency exchange control regulations ("exchange regulations"), the Central Bank of Venezuela (BCV) centralizes the purchase and sale of foreign currency in the country. Under these regulations, the purchase and sale of foreign currency must be made at the official rate of exchange, which is the rate that is fixed from time to time by the executive branch and the BCV. In October 2005, the Venezuelan government enacted the Criminal Exchange Law, which 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, the law exempts the purchase and sale of securities. Although the law does not explicitly define "securities," we understand that, in practice, securities include both (1) national public debt bonds (DPNs) denominated in *bolivar fuertes* and (2) bonds issued by the Venezuelan government that are denominated in U.S. dollars. This exemption for transactions in certain securities has created an indirect "parallel" foreign currency exchange market in Venezuela that enables entities to use brokers to obtain foreign currency without having to purchase the currency from the Commission for the Administration of Foreign Exchange (CADIVI) at the official rate. The average rate of exchange in the parallel market varies and is less favorable than the official rate. While the Criminal Exchange Law precludes brokers or financial institutions from publishing foreign exchange quotes or trading volumes, the IPTF understands that the purchase and sale of dollar-denominated securities through the parallel market has been determined to be legal and has been an accepted method of converting bolivars to dollars.

ASC 830 specifies the exchange rates that should be used for translation of foreign currency transactions ("remeasurement") and foreign currency statements ("translation").

Remeasurement of Foreign Currency Transactions

ASC 830-20-30-3 (formerly paragraph 27(a) of Statement 52) indicates that entities should use the applicable rate at which a transaction could settle as of the transaction date to translate and record the transactions. In its November 25, 2008, meeting, the IPTF noted that the determination of whether the Criminal Exchange Law changed a registrant's ability to access the parallel market should be made by the registrant's management in consultation with legal counsel, if necessary. In other words, if the registrant determines that the parallel market is readily available for the settlement of dollar-denominated transactions, then the following view, outlined by the IPTF at its meeting on November 21, 2006, should continue to be followed:

> [T]he rate used for re-measurement of foreign currency denominated transactions into the functional currency depends on the type of transaction being re-measured. Since the Criminal Exchange Law, by virtue of exemption, provides for a parallel exchange mechanism and since there is an observable market rate of exchange for securities traded in this market, based on facts and circumstances this market rate may be appropriate for the re-measurement of foreign currency denominated transactions that could be settled through the parallel market mechanism.

In addition, the IPTF noted the following at its November 25, 2008, meeting:

> If it is determined that the parallel market is not a readily available means by which U.S. dollar denominated transactions can be settled, then the official rate should be used for all U.S. dollar denominated transactions.

Highlights of the meetings also indicated that the SEC staff agreed with the above views.

Translation of Foreign Currency Statements

ASC 830-30-45-6 (formerly paragraph 27(b) of Statement 52) indicates that in "the absence of unusual circumstances, **the [exchange] rate applicable to conversion of a currency for purposes of dividend remittances shall be used to translate** foreign currency statements" (emphasis added). In the past, the IPTF has indicated that the official rate should be used for foreign currency translation because only that rate could be used to remit dividends. The SEC did not object to this view.

However, many entities have had difficulty repatriating dividends when using the official rate, and some have reportedly begun to use the parallel market for dividend remittances. On its Web site, the U.S. Department of State notes the following about repatriation of dividends from Venezuela:

> Foreign companies wishing to repatriate capital, dividends, or profits at the official rate have to get authorization from CADIVI. In 2008, CADIVI authorized approximately USD 1.17 billion in repatriations. However many companies did not receive the full authorization they requested from CADIVI or received it after delays of six months or more. Some companies have therefore turned to the parallel market for repatriation.

Furthermore, the SEC staff has continued to discuss whether the parallel market or official rate should be used for translation under ASC 830. The SEC acknowledged at the 2009 AICPA Conference that there may be instances in which the parallel rate may be used and stated that there is no “one size fits all” approach to determining the appropriate exchange rate. Rather, this determination should be based on individual facts and circumstances, and entities should be prepared to support their conclusion to auditors and regulators.

Accordingly, some entities could possibly now make a case in favor of using the parallel market rate for foreign currency translation. As noted above, ASC 830-30-45-6 (formerly paragraph 27(b) of Statement 52) states that the exchange rate used for currency conversion of dividend remittances also should be the exchange rate used for translation of foreign currency financial statements. Furthermore, paragraph 138 of the Basis for Conclusions of Statement 52 notes:

> The Board has concluded that if multiple rates exist, the rate to be used to translate foreign statements should be, in the absence of unusual circumstances, the rate applicable to dividend remittances. Use of that rate is more meaningful than any other rate because cash flows to the reporting enterprise from the foreign entity can be converted at only that rate, and realization of a net investment in a foreign entity will ultimately be in the form of cash flows from that entity.

Therefore, an entity that has used, or concludes that it will or could use, the parallel market rate for repatriation of capital or dividends may be able to argue that the parallel market rate is the appropriate exchange rate to use for foreign currency translation. Such a determination would need to be made on the basis of the entity's specific facts and circumstances and supported by sufficient competent evidence, including, but not limited to, the following:

- Sufficient evidence that the use of the parallel market rate for dividend remittance purposes is legal.
- Sufficient evidence to support an entity's assertion that it will be able to obtain the requisite volume of qualifying securities in the future to enable it to use the parallel market rate for dividend remittances.

Other factors an entity may consider in its determination of the dividend remittance rate to use for foreign currency translation include, but are not limited to, the following:

- The entity's intent and ability to use a particular rate for dividend remittances, including a retrospective assessment of the entity's ability to use a particular rate.
- The positive or negative impact the entity's industry may have on its ability to use the official rate for dividend remittances (e.g., certain industries may receive preferential treatment by CADIVI, which may influence the likelihood that an entity in the industry would be able to avail itself of the official rate).
- The volume of potential or anticipated dividend remittances based on an assessment of accumulated unremitted earnings and the positive or negative impact such volume may have on the entity's ability to use a particular rate for dividend remittances.

Disclosures

Because of the circumstances regarding exchange controls, additional disclosures may be necessary. Financial reporting considerations related to an entity's use of a particular rate for remeasurement of foreign currency transactions and translation of foreign currency statements include, but are not limited to, the following:

- Disclosure of the exchange rate used for remeasurement and translation and of the effect or potential effect on the financial statements.
- Disclosure of the net monetary assets and liabilities, disaggregated by the currency (e.g., bolivars, dollars) in which they are denominated.
- Disclosure of summarized financial information about the entity's Venezuelan operations.
- MD&A discussion of the potential impact that a change in the exchange rates used for remeasurement or translation would have on the entity's financial statements.

Devaluation of the Bolivar

On Friday January 8, 2010, after close of business in the financial markets, Venezuelan President Hugo Chavez announced the devaluation of the bolivar (BsF). The official exchange rate of 2.15 bolivars to the dollar, in effect since 2005, was replaced effective January 11, 2010, with a dual-rate regime. The two-tiered official exchange rates will be (1) “the essentials rate” at BsF 2.60 per dollar and (2) “the non-essentials rate” at BsF 4.30 per dollar.

The president announced that importers of essential items such as food, medicine, heavy machinery, family remittances, and public sector imports including school supply, science, and technology needs, will be able to buy dollars at a rate of 2.60 bolivars, which represents a 17 percent devaluation. However, a higher rate of 4.30 bolivars — representing 100 percent devaluation — will apply to most of the economy, including the automobile, chemicals, rubber and plastics, appliances, textile, electronics, tobacco, beverages, and telecommunications sectors, as well as to repatriation of dividends by foreign investors. President Chavez also announced that

Venezuela’s Central Bank will “participate” in the unofficial parallel currency market, in which importers unable to buy sufficient dollars from the government because of currency controls pay up to three times the old official rate (i.e., 6.00 bolivars). He also announced a series of “incentives” for companies that obtain “necessary imports.”

ASC 830-20-30-1 specifies that when exchangeability between two currencies is lacking as of the balance sheet date, the exchange rate on the first subsequent date of trading should be used. Questions have arisen about whether there have been exchanges of U.S. dollars and bolivars between December 31, 2009, and January 11, 2010. Absent evidence to the contrary, it appears that exchangeability did exist as of December 31, 2009. Accordingly, the exchange rate used should be the rate in effect on December 31, 2009. Entities should consider all relevant facts and circumstances and be prepared to support their conclusion regarding exchangeability. The SEC staff and IPTF are aware of this question, but it is unclear at this time whether formal guidance will be issued. An entity should also consider the guidance in ASC 830-20-50-2, which states:

> Disclosure of a rate change that occurs after the date of the reporting entity's financial statements and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary. If disclosed, the disclosure shall include consideration of changes in unsettled transactions from the date of the financial statements to the date the rate changed. In some cases it may not be practicable to determine these changes; if so, that fact shall be stated.

Furthermore, ASC 830-20-50-3 states:

> Management is encouraged to supplement the disclosures required by this Subtopic with an analysis and discussion of the effects of rate changes on the reported results of operations. This type of disclosure might include the mathematical effects of translating revenue and expenses at rates that are different from those used in a preceding period as well as the economic effects of rate changes, such as the effects on selling prices, sales volume, and cost structures. The purpose is to assist financial report users in understanding the broader economic implications of rate changes and to compare recent results with those of prior periods.

Registrants should consider the need to include, in the descriptions of the business, risk factors, and MD&A sections of their SEC filings, relevant disclosure of foreign operations in economic environments that are either highly inflationary or are trending toward highly inflationary status. Also, entities that have operations in or transact with Venezuela should consider disclosing the inflation index they used to determine whether Venezuela is a highly inflationary economy. The SEC staff indicated at the 2009 AICPA Conference that MD&A disclosures in this area have been lacking. Accordingly, the SEC staff expects registrants’ future filings to include robust disclosures on the potential financial statement impact of the economic uncertainties in Venezuela. We believe that as a result of the devaluation of the bolivar, registrants with significant Venezuelan operations should consider expanding those disclosures even further. Such registrants should note that Item 303 of Regulation S-K requires discussion pertaining to “Results of Operations” in an entity’s MD&A disclosure and that paragraphs (a)(3)(i) and (ii) require entities to do the following (in part):

> (i) Describe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected.
>
> (ii) Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

Moreover, in December 2003, the SEC issued interpretive guidance on MD&A[7] in which it discussed the content and focus of MD&A. Regarding material trends and uncertainties, the Commission stated:

> One of the principal objectives of MD&A is to provide information about the quality and potential variability of a company's earnings and cash flow, so that readers can ascertain the likelihood that past performance is indicative of future performance. Ascertaining this indicative value depends to a significant degree on the quality of disclosure about the facts and circumstances surrounding known material trends and uncertainties in MD&A. Quantification of the material effects of known material trends and uncertainties can promote understanding. Quantitative disclosure should be considered and may be required to the extent material if quantitative information is reasonably available.

> As discussed in the 1989 Release,[8] the disclosures required to address known material trends and uncertainties in the discussion and analysis should not be confused with optional forward-looking information. Not all forward-looking information falls within the realm of optional disclosure. In particular, material forward-looking information regarding known material trends and uncertainties is required to be disclosed as part of the required discussion of those matters and the analysis of their effects. [Footnote omitted]

Financial Reporting Matters

In addition to the disclosure considerations discussed above, registrants should, in preparing their financial statements (including those for disclosure purposes as of December 31, 2009), consider the following as they assess how the uncertainties regarding operations in Venezuela may affect their current and future consolidated financial statements.

- If an entity believes that a change in the exchange rate used for translation is warranted (i.e., from the official rate to the parallel rate) **at the end of its reporting period** (i.e., December 31, 2009), is there a need to use a consistent rate to translate the underlying transactions recorded in the income statement and the statement of cash flows for the same reporting period (i.e., the entity's fourth quarter)?
- Will an entity's dollar equivalent revenues and operating costs in 2010 be significantly reduced relative to those from 2009 if bolivar denominated revenues and operating costs have to be remeasured to dollars at the devaluated rates instead of those used in 2009, and should the expected reduction in revenues and costs be disclosed?
  - Assume that during 2009 an entity generated revenues of 50 million bolivars and translated the financial statements at the official rate of BsF 2.15 (i.e., recorded $23.25 million in revenues). If during 2010 the entity generated the same amount of bolivar revenues (i.e., BsF 50 million), the dollar equivalent that would be included in the consolidated financial statements would be significantly lower as a result of the devaluation or need to use the parallel rate in 2010.
- Does an impairment exist on nonmonetary assets (e.g., PP&E or inventory) as a result of expected dollar equivalent net cash flows being significantly lower because of an entity's conversion of bolivars into dollars at devalued rates?
  - The significant disparity between the official rate and the newly devalued rates may result in an impairment. For example, impairment may exist if a Venezuelan subsidiary generates cash flows in bolivars for which the equivalent U.S dollar amounts used in an impairment test (e.g., lower of cost or market or undiscounted cash flow analysis) may be significantly lower because of the recent devaluation of the bolivar.
- Does an other-than-temporary impairment exist on equity method investments or available-for-sale securities of Venezuelan entities as a result of the economic uncertainty?
- On the basis of information and events available as of the date of the impairment test, are receivable and loan balances of Venezuelan companies impaired? The collectability of a receivable or loan balance may not, in and of itself, be affected by the devaluation of the currency. However, an entity should consider all current information in assessing the debtor's ability to pay.
- Does a Venezuelan subsidiary holding U.S dollar denominated monetary assets or liabilities as of December 31, 2009, need to adjust those balances upon a change in functional currency as a result of having used a different exchange rate for remeasurement and translation?
  - Assume that on January 1, 2009 (a year before transition to highly inflationary status), a Venezuelan subsidiary of a U.S. parent holds $100 in an off-shore bank account. Since this cash balance represents a foreign currency denominated monetary asset for the Venezuelan entity, assume that the parallel rate of 6/$1 was used to periodically remeasure this cash into bolivar functional currency, resulting in 600

bolivars. Further assume that the company translated this balance into U.S. dollars (i.e., into the U.S. dollar reporting currency of the parent) for consolidation purposes at the official rate of 2/$1, reflecting cash in consolidation of $300.

ASC 830 requires that the U.S. dollar be the functional currency for the Venezuelan subsidiary at the beginning of the reporting period upon transition to highly inflationary accounting. Accordingly, the U.S. dollar denominated cash that has been reflected in the parent's consolidation balance sheet at $300 would need to be adjusted down to $100. Registrants that face this situation should consider whether the difference of $200 (before and after the highly inflationary transition) in that example should be recognized as an income statement charge or recorded as an adjustment to the cumulative translation adjustment (CTA) within other comprehensive income.

ASC 830 does not directly address this situation. However, the underlying objective of ASC 830 is for entities to present information that is generally comparable with the expected economic effects of a rate change on an entity's cash flows and equity. The SEC staff is aware of this particular issue and may issue guidance in the near future. Registrants facing this situation should provide robust disclosures in their December 31, 2009, financial statements.

- Would Venezuela's transition to highly inflationary accounting (e.g., a Venezuelan entity's functional currency changes to the reporting currency of the parent) affect the subsequent accounting for derivatives currently designated in a qualifying hedge accounting relationship under ASC 815 (formerly Statement 133[9])? ASC 815-20-25-30(b) requires the hedged transaction in a foreign currency cash flow hedge, foreign currency fair value hedge, or net investment hedge to be "denominated in a currency other than the hedging unit's functional currency." Consideration should be given to whether hedge accounting is no longer appropriate after the transition to highly inflationary status because the hedged risk no longer represents a risk exposure that is eligible for hedge accounting. Examples would include the following:
    - **Hedging unit is parent.** A parent's net investment in a Venezuelan subsidiary would no longer meet the condition in ASC 815-20-25-30(b) once the financial statements of the Venezuelan subsidiary have been remeasured to the functional currency of the parent (i.e., the net investment in the Venezuelan subsidiary will not be considered denominated in a functional currency that is different from the hedging unit's functional currency).
    - **Hedging unit is Venezuelan subsidiary**. The hedged transaction in a foreign currency cash flow hedge (or the hedged item in a foreign currency fair value hedge) previously designated by a Venezuelan subsidiary may be denominated in a currency that, after transition to highly inflationary status, is now the functional currency of the Venezuelan subsidiary. After the transition to highly inflationary status, such hedge would not meet the condition in ASC 815-20-25-30(b) because it no longer represents a foreign currency exposure of the Venezuelan subsidiary (i.e., the hedged transaction is not denominated in a currency other than the hedging unit's functional currency).
- Will an entity that recognized a deferred tax liability on unremitted earnings of a Venezuelan subsidiary need to reduce that liability as a result of the devaluation (the devaluation will reduce the dollar tax payable when dividends are paid)?

Other Financial Reporting Considerations

Income Tax Accounting

When the functional currency is the reporting currency, ASC 740-10-25-3(f) (formerly paragraph 9(f) of Statement 109[10]) states that it prohibits the recognition of a deferred tax liability or asset for certain temporary differences that arise with respect to:

> assets and liabilities that . . . are remeasured from the local currency into the functional currency using historical exchange rates [i.e., nonmonetary items and revenue or expense items related to nonmonetary items] and that result from changes in exchange rates or indexing for tax purposes.

ASC 830-10-45-16 (formerly Topic D-56[11]) clarifies that it is not appropriate to revise deferred tax assets and liabilities on the books as of the date of conversion to a highly inflationary economy. Rather, such assets and liabilities will be eliminated at the time the tax deduction is taken. In Venezuela, net operating losses are available to be carried forward for three years, except for losses arising from inflation adjustments, which can be carried forward for one year. Losses are not subject to indexation for inflation. The recognition of deferred tax assets for losses will not be affected by the application of ASC 830-10-45-16.

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1 Venezuela has two inflation indices. One is a metropolitan index, which covers two large cities and was the sole measure before January 1, 2008. The other is a newer national index that has been in use since January 1, 2008.

2 For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's **"Titles of Topics and Subtopics in the FASB Accounting Standards Codification."**

3 EITF Topic No. D-55, "Determining a Highly Inflationary Economy Under FASB Statement No. 52."

4 FASB Statement No. 52, *Foreign Currency Translation*.

5 The International Practices Task Force (IPTF) of the Center for Audit Quality (CAQ) SEC Regulations Committee meets periodically with the SEC staff to discuss emerging international technical accounting and reporting issues related to SEC rules and regulations. Discussions of the IPTF meetings have not been considered and acted on by senior technical committees of the AICPA or by the FASB and do not represent an official position of either organization. In addition, these discussions do not represent authoritative positions or interpretations issued by the SEC or its staff.

6 IAS 29, *Financial Reporting in Hyperinflationary Economies*.

7 SEC Interpretive Release No. 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*.

8 SEC Interpretive Release No. 33-6835, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*.

9 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

10 FASB Statement No. 109, *Accounting for Income Taxes*.

11 EITF Topic No. D-56, "Accounting for a Change in Functional Currency and Deferred Taxes When an Economy Becomes Highly Inflationary."

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