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Agenda paper 4

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# *"ACCOUNTING FOR THE EFFECTS OF INFLATION"*

## April 7, 2016

# Presentation content

- **Introduction-*main effects of inflation***
- **Alternative solutions**
- **Proposed level of inflation**
- **Proposed restatement mechanism**

# Main effects of inflation

**Main impacts on financial statements not restated for the effects of inflation are the following:**

1. **Unrecognized gains or losses due to the exposure of monetary items to inflation…**

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# Main effects of inflation

| *Gain/loss on net monetary position* | X1 | Effect | X1 | |
|---|---|---|---|---|
| *X1 Inflation=10%* | | 10% | Restated | |
| Monetary assets | 600 | 60 | 600 | (1) |
| Monetary liabilities | 400 | 40 | 400 | (1) |
| *Net monetary position* | 200 | 20 | 200 | |
| Non-monetary assets | 800 | 80 | 880 | |
| Equity | 1,000 | 100 | 1,100 | |
| *Loss on net monetary position* | | | - 20 | (2) |
| | 200 | 20 | 200 | |

(1) Monetary items should not be restated because they are expressed in terms of the monetary unit current at the end of the reporting period.

(2) Consequently, a loss should be recognized.

# Main effects of inflation

**Main impacts on financial statements not restated for the effects of inflation are the following:**

1. Unrecognized gains or losses due to the exposure of monetary items to inflation.
2. It is impossible to determine the amount corresponding to capital maintenance; consequently, without knowing the growth in equity in real terms, there is no sound basis for the distribution of earnings or dividends to shareholders…

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# Main effects of inflation

## Capital maintenance

| *Has the equity increased?...* | X1 | X2 Restated | X2 vs X1 |
|---|---|---|---|
| Monetary assets | 600 | 700 | 100 |
| Monetary liabilities | 400 | 450 | 50 |
| *Net monetary position* | 200 | 250 | 50 |
| | | | |
| Non-monetary assets | 880 | 1,100 | 220 |
| Equity | 1,080 | 1,350 | 270 |
| | 200 | 250 | 50 |

*X1 should be restated to be comparable with X2...*

# Main effects of inflation

## Capital maintenance

*...equity has decreased!*

*X2 Inflation=30%*

| | X1 | X1 Restated | X2 Restated | X2 vs X1 |
|---|---|---|---|---|
| Monetary assets | 600 | 780 | 700 | - 80 |
| Monetary liabilities | 400 | 520 | 450 | - 70 |
| *Net monetary position* | 200 | 260 | 250 | - 10 |
| | | | | |
| Non-monetary assets | 880 | 1,144 | 1,100 | - 44 |
| Equity | 1,080 | 1,404 | 1,350 | - 54 |
| | 200 | 260 | 250 | - 10 |

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# Main effects of inflation

## Capital maintenance

*Concerning the example:*

- **X1 restated: 1,404 includes equity maintenance . Then:**
  - **Real increase: over $1,404.**
  - **Real decrease: under $1,404.**
- **X2 equity decreased in real terms vs X1 restated ($54).**
- **If the company distributes $270 (without consider the equity maintenance, first slide), there will be a decapitalization.**

***Conclusion: It is necessary to restate the financial statements to have the best base to make decisions in an inflationary environment.***

# Main effects of inflation

**Main impacts on financial statements not restated for the effects of inflation are the following:**

1. Unrecognized gains or losses due to the exposure of monetary items to inflation.
2. It is impossible to determine the amount corresponding to capital maintenance; consequently, without knowing the growth in equity in real terms, there is no sound basis for the distribution of earnings or dividends to shareholders.
3. Distortion of the presentation of income and expenses due to the inappropriate comparison of items stated in currency of different purchasing power.

# Actual cases of public companies

***We checked some public companies…***

## Unrestated financial statements presented the following results:

| Companies | Profit for the year | Earnings per share |
|---|---|---|
| 1 | 2,987 | 6.32 |
| 2 | 105 | 0.13 |

## Restated financial statements presented the following results:

| Companies | Loss for the year | Loss per share |
|---|---|---|
| 1 | (425) | (0.84) |
| 2 | (376) | (0.13) |

# Actual cases of public companies

*Concerning the actual cases of public companies:*

- **The restated financial statements include inflation losses.**
- **Unfortunately, the companies distributed dividends based on the financial statements without restatement. This caused significant decreases in the value of their equity.**

***Conclusion: the companies should not make decisions based on unrestated financial statements; it is risky.***

# Alternative solutions

## Adopt constant currency accounting

- **The goal here is to measure all figures of the financial statements in currency with the same purchasing power (the one corresponding to the closing date of the latest period presented).**
- **This permits recognizing the amount of capital maintenance and eliminates distortions of financial statements, especially in the statement of profit or loss.**
- **Countries with medium and high inflation, but not hyperinflation, have used this method of restatement with very satisfactory results.**

**We recommend this method.**

# Alternative solutions

## Disclosure of restated information:

- **Countries having medium and high levels of inflation have used this proposal, but the experience was unsatisfactory.**
- **Most users found it confusing to have two different results: on financial statements and on disclosures; it is difficult to understand the differences between them.**
- **Only disclosing restated information was discontinued and prohibited by the standard setters because of the misleading and confusing information provided to users.**

**We do not recommend this method.**

# Proposed level of inflation

## Proposals

- We believe that financial statements are distorted if the effects of inflation are not recognized: Such financial statements are misleading.

- Based on our experience, we recommend that the recognition of the effects of inflation be made when the cumulative three-year inflation rate is 26% (approx. 8% per year).

- In IAS 29, we suggest replacing the reference to 100% cumulative three-year inflation with 26% to trigger restatement.

# Proposed restatement mechanism

## Economic environment

1. **Inflationary**: **when inflation levels cause the local currency to depreciate significantly with regard to its purchasing power, it can no longer be considered a point of reference for settling financial transactions. When the cumulative three-year inflation rate is 26% or higher, *restatement should be required.***

2. **Non-Inflationary**: **when inflation is not relevant and, is considered to be controlled in the country; this means that the effects of inflation are not material. When the cumulative three-year inflation rate is less than 26%, *restatement should not be required.***

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# Proposed restatement mechanism

## Restatement of financial statements

**Constant currency accounting: to use this method**

- ***Measurement of assets, liabilities and equity:***
  - **Monetary items:** should not be restated.
  - **Non-monetary assets:** should be restated. It is possible to use fair value measurement.
  - **Equity:** should be restated.
- ***Measurement of profit and loss:***
  - **Profit and loss:** should be restated in constant currency.
- ***Disclosures***
  - **Restatement disclosures:** should be included in the notes to the financial statements.

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# Reasons of the proposal

- **Based on our experience, we recommend replacing the 100% threshold of 26%, meaning about 8% annual.**
- **Also, based on our previous experience, we can say that an inflation rate 8% is not sustainable over a prolonged period.**
- **Empirical evidence shows that environments evolve into a reduction of the rate to certain limits, which can be sustained during prolonged periods (to less than 3% annual) or to a substantial increase in the inflation rate.**

# Reasons of the proposal

- Empirical demonstrations show that the distortion is significantly higher when the inflation rates are higher than in stable economies.
- It is necessary to establish a reference point that justifies the costs and efforts necessary for preparers to produce the corresponding changes to the nominal financial information.
- All parameters are arbitrary and cannot be demonstrated; our opinion is based in our experience from having lived and worked over prolonged periods in environments with high, medium and low inflation rates, and having prepared and analyzed financial information, both with and without restatement of financial information.

# Appendix

**Part I – Main inflation effects**

**I.1 Inflation effect on equity.**

**Part II – In this Part II, we include some documents which have been presented previously to the Emerging Economies Group**

**II.1 Introduction.**

**II.2 Inflation disclosure project.**

**II.3 High inflation accounting proposed disclosure. Some examples are Included**

**II.4 Comments on Agenda Paper 14, Inflation Project.**

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# Thank you very much !!