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STAFF PAPER

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Project	Price-Level Adjusted Financial Statements	
Paper topic	For Discussion at the December 2013 Meeting	
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Introduction and objective

1. This paper and its attachments are one of two packages for the December 2013 meeting of the IASB's Emerging Economies Group (EEG). The other package, prepared by a group of Latin-American standard setters proposes a specific solution modelled on expanding the application of IAS 29, *Financial Reporting in Hyperinflationary Economies*. This paper addresses some of the history, conceptual issues, and practical issues surrounding the question of whether, and if so, how financial reporting should take account of price level changes and their effects on the carrying amounts of assets and liabilities.

2. A word on terminology is important here. Writers on this topic tend to be very careful in describing the topic they are addressing. Terms like *inflation accounting* are easy to understand but imprecise. More specific terms are often coupled with specific methodologies and are thus hard to generalise. I have adopted *price level changes* in this paper to refer to the family of approaches that have been proposed at one time or another.

3. The EEG's discussions in December, like those at many of our meetings, will feed into the (unstarted) project on the IASB's research agenda.

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Why address price level changes?

4. FASB Vice Chairman David Mosso made the case this way, in his dissent to FASB Statement 89, *Financial Reporting and Changing Prices*,

> Mr. Mosso dissented to the issuance of Statement 33 and he dissents to its rescission, both for the same reason. He believes that accounting for the interrelated effects of general and specific price changes is the most critical set of issues that the Board will face in this century. It is too important either to be dealt with inconclusively as in the original Statement 33 or to be written off as a lost cause as in this Statement.
>
> The basic proposition underlying Statement 33—that inflation causes historical cost financial statements to show illusory profits and mask erosion of capital—is virtually undisputed. Specific price changes are inextricably linked to general inflation, and the combination of general and specific price changes seriously reduces the relevance, the representational faithfulness, and the comparability of historical cost financial statements.
>
> Although the current inflation rate in the United States is relatively low in the context of recent history, its compound effect through time is still highly significant. High inflation rates prevail in many countries where United States corporations operate. Rates from country to country vary from time to time. Those distortive influences on financial statements will now go unmeasured and undisclosed.

5. The problem described in David's dissent can be illustrated with a simple case. Suppose a company has one asset that is reported following IAS 16, *Property, Plant and Equipment* and was purchased for CU 1000. The asset has a three year life and no residual value. Price levels increase at 10 percent per year. Revenues are CU 500 in year one, 550 in year two, and 605 in year 3. For simplicity, I assume that all revenues are collected in cash on the first day of each year and invested at 10 percent. Net income is distributed as a dividend on the last day of each year.

	Year 1	Year 2	Year 3
		dr (cr)	
Operating statement			
Revenue	(500.00)	(550.00)	(605.00)
Interest income	(50.00)	(88.30)	(127.10)
Depreciation	333.00	333.00	334.00
Net income	(217.00)	(305.30)	(398.10)
Statement of Financial Position			
Cash and investments	333.00	666.00	1,000.00
Asset	1,000.00	1,000.00	1,000.00
less accumulated depreciation	(333.00)	(666.00)	(1,000.00)
Initial capitalisation	(1,000.00)	(1,000.00)	(1,000.00)
Retained earnings	-	-	-

Illustration 1

6. Remember, this is a simple illustration, but it makes the point of those who support some sort of price-level adjustment in financial statements. In their view, net income in years two and three is overstated. That, coupled with the assumed dividend policy, leaves the company without enough cash to replace the asset at the beginning of year four. The financial statements reflect capital maintenance in nominal currency units but the economy is one of changing price levels.

7. The question isn't new, though. For example:

   (a) In the 1950s, William Paton chided accountants for their failure to recognise the effects of price level changes.[1]

   (b) In 1963, the American Institute of CPAs published Accounting Research Study No 6, *Reporting the Financial Effect of Price-Level Changes*. In 1969, the APB issued Accounting Principles Board (predecessor to the FASB) Statement No. 3, *Financial Statements*

[1] See for example, "Measuring profits under inflation conditions: A serious problem for accountants." Journal of Accountancy, January 1950.

Restated for General Price-Level Changes. APB Statements, as opposed to APB Opinions, did not require a change in practice. The FASB observed that very few companies followed APB Statement 3.

(c) In 1977, the IASC issued IAS 6, *Accounting Responses to Changing Prices.* In 1981, the IASC issued IAS 15, *Information Reflecting the Effects of Changing Prices*, which superseded IAS 6. IAS 15 was not mandatory (following a 1989 IASC decision) and was withdrawn by the IASB in 2003.

(d) In 1979, the FASB published FAS 33, *Financial Reporting and Changing Prices.* FAS 33 was withdrawn in 1986.

(e) In 1984, before their careers in standard setting, David Tweedie and Goeffrey Whittington authored *The Debate on Inflation Accounting*.

(f) In 1989, the IASC issued IAS 29, *Financial Reporting in Hyperinflationary Economies.*

(g) In 2010, a group of Latin American standard setters proposed a revised version of IAS 29 (attached).

8. At its September 2013 meeting, the IFRS Interpretations Committee considered a paper titled, "Applicability of the concept of financial capital maintenance defined in constant purchasing power units." That paper (attached) dealt with a submission from Nicolaas Smith. Mr. Smith is the author of a 2012 book titled, *Constant Item Purchasing Power Accounting per IFRS*[2]. In his book and his submission he maintains that the IASB's *Conceptual Framework for Financial Reporting* (the *Framework*) enables any company to prepare financial statements adjusted for price level changes. As outlined in the attached materials, he refers to the paragraphs in the *Framework* that address capital maintenance concepts and the provisions of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* that govern selection of accounting policies when no specific IFRS is on point.

9. The Interpretations Committee disagreed. In their tentative agenda rejection notice, they said:

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[2] Available in eBook format from Amazon.com.

> The Interpretations Committee observed that the guidance in the Conceptual Framework is written to assist the IASB in the development of Standards and that it is also used in the development of an accounting policy only when no IFRSs specifically apply to a particular transaction, other event or condition and no IFRSs deal with similar and related issues. Consequently the guidance in the Conceptual Framework relating to the use of a particular capital maintenance concept cannot be used to override the requirements of individual IFRSs. An entity is not permitted to apply a concept of capital maintenance that conflicts with the existing requirements in a particular IFRS, when applying that IFRS. [Update attached.]

10. One Board Member has indicated disagreement with this conclusion, at least in part. To summarise this Board Member's view, the scope paragraphs of IAS 29 do not *prohibit* its application in situations that are not hyperinflationary. Stated differently, the scope paragraphs do not contain the "if and only if" language found in other IFRSs. Further, this Board Member does not conclude that existing IFRSs prohibit the use of price-level adjusted financial statements. Instead, this Board Member sees price-level adjusted financial reporting as an overlay on existing IFRSs rather than a departure.

11. A full discussion of this view is beyond the scope of the EEG meeting, but two points are worth noting. First, none of the firm publications on IFRS explore the possibility of expanding application of IAS 29 to situations that are not hyperinflationary. In fairness, they may never have been asked the question. Second, the firm publications treat the language in paragraph 38 of IAS 29 as a *requirement* to cease application when the economy ceases to be hyperinflationary. That position is inconsistent with a permissive view of the Standard's scope. The Board Member does not view paragraph 38 as a requirement.

What to do?

12. The big question, then, is should the IASB pursue a project on incorporating price level changes in financial statements? It is too soon to ask that question. To

paraphrase a former US President, we can't decide on "it" until we have a common understanding of what "it" is.

Scope

13. It is easy to jump directly to the techniques for dealing with price-level changes, but I suggest that the EEG start with the question of scope.

> Question One: Assuming the IASB decides to pursue a research project on price-level adjusted financial reporting, to which financial statement elements should adjustments apply?

14. Question One begins the discussion with restatement in the primary financial statements rather than supplemental disclosure. We will turn to disclosure-based approaches later in the discussion.

15. Scope, then, focuses on which assets and liabilities and which situations. I suggest we look first at which assets and liabilities.[3]

Which assets and liabilities?

16. It is, or should be, axiomatic that we are talking here about changes to the recorded amounts of assets and liabilities. Revenues and expenses, gains and losses, are the consequences of increasing or decreasing assets and liabilities. That change may be instantaneous, as the Board observed in IFRS 2, *Share-based Payment.* In IFRS 2, the Board concluded that the expense arising from employee share-based payments arises in two steps. First, the employer acquires an asset – the services. Second, that asset is consumed, resulting in the expense.

17. IAS 29 takes a traditional approach of separating monetary and nonmonetary assets and liabilities. Paragraph 12 says:

> Monetary items are not restated because they are already expressed in terms of the monetary unit current at the end of the reporting period. Monetary items are money held and items to be received or paid in money.

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[3] IAS 29 also requires adjustments in the statement of cash flows. For our purposes, we will keep the focus on the statement of financial position.

18. That assertion is correct, as far as it goes. However, we should ask whether some monetary items are affected by price-level changes in a way similar to nonmonetary assets. (Nicolaas Smith makes, I think, a similar point.) If the objective of the exercise is to portray the effects of general or specific price-level changes on capital maintenance, then perhaps some of these items should be adjusted as well.

19. Consider the case of a fixed coupon note and substitute it for the asset shown in Illustration 1. Changing price levels usually affect interest rates and would affect the fair value of the note. That effect is not represented in the financial statements if the note is measured using the amortised cost method.

20. An alternative approach might focus on the measurement attributes of assets and liabilities and whether the attribute or some other characteristic of the item is a basis for excluding it. Examples might include:

    (a) Current assets and liabilities, because the effect is likely to be immaterial;

    (b) Assets and liabilities linked to changes in prices (usually financial instruments, but not always);

    (c) Items measured at fair value, because market participants would already have incorporated past and expected future price-level changes in their evaluations;

    (d) Items not measured at fair value, but that are based on a measurement that employs current estimates of future cash flows and interest rates (provisions under IAS 37, for example) and,

    (e) Most deferred taxes, because the measurement is derived from temporary differences between the tax basis and financial statement carrying amount of an asset or liability. The argument here would be that adjusting deferred taxes for price-level changes would be double counting.

21. What about shareholders' equity? Examples of IAS 29 in the various firm handbooks show indexes applied to paid-in capital in the same manner as nonmonetary assets and liabilities. Retained earnings is a residual amount and

thus incorporates all of the indexing adjustments already made to assets and liabilities.

22. I think it is worth asking whether amounts of paid-in capital *should* be adjusted for price level changes. One could argue that the proceeds of paid-in capital are used to acquire assets, which are then the subject of indexation. The results, and thus the capital maintenance adjustment, are captured in the adjustments to assets and liabilities. Indexing paid-in capital, in this view, would be double counting.

23. Alternatively, one could argue that the objective is to present all financial statement elements using a common base. Given that, all eligible items should be restated.

Which situations?

24. IAS 29 is a trip-wire standard. It is required only in situations of hyper-inflation. The 2010 proposal mentioned earlier lowers the trip wire, but continues to limit applications to situations in which price-level effects are deemed significant. Both decisions were, I suspect, motivated by a cost-benefit decision. Any approach to price-level adjustment will be expensive and difficult to apply. However, consider the effect of price-level changes on the carrying amounts and depreciation of an asset with a 20-year life, no residual value and price-level changes at a constant rate of 6 percent. Illustration 2 below shows one possible (but not the only) approach to incorporating those changes.

Price level changes at		6.00%		
Year	Carrying amount	Depreciation	Accumulated depreciaition	Net carrying amount
0	1000			
1	1060	53	53	1007
2	1124	56	109	1014
3	1191	60	169	1022
4	1262	64	234	1029
5	1338	69	303	1035
6	1419	74	377	1041
7	1504	80	458	1046
8	1594	87	545	1049
9	1689	95	640	1049
10	1791	105	745	1046
11	1898	115	860	1038
12	2012	128	988	1024
13	2133	143	1131	1002
14	2261	161	1293	968
15	2397	184	1477	920
16	2540	213	1689	851
17	2693	251	1940	753
18	2854	305	2245	609
19	3026	390	2635	390
20	3207	572	3207	0

Illustration 2[4]

20. Another potential problem with a trip-wire approach is that the standard, and the preparers and users of financial statements, must deal with stopping and starting application. That is a problem worth considering in an IASB research project on the topic, but is probably beyond the EEGs ability to address in a one-day session.

21. Finally, there is the question of incorporating price-level adjusted financial statements in the consolidated statements of a parent that does not apply price-level adjusted measures. Some have maintained that the result seems illogical.

22. For our purposes, I would pose the question like this:

23. Is price-level adjusted financial reporting based on a concept of capital maintenance, in which case it should *always* be applied, at least in concept? Alternatively, is it a response to particular conditions and necessary to prevent the financial statements of companies operating in those situations from being

[4] Amounts are rounded to a single decimal place. As a result, some rows to not total to the amounts shown.

misleading, in which case it should be applied only when those conditions exist? We will return to these questions in the section on Objectives.

Techniques

> Question Two: Assuming the IASB decides to pursue a project on price-level adjusted financial reporting, which approach should it pursue?

24. There are a variety of approaches to the problem. In the defined terms of FAS 33, the FASB described the approaches as follows [Underlining added]:

> *Constant dollar accounting*. A method of reporting financial statement elements in dollars each of which has the same (i.e., constant) general purchasing power. This method of accounting is often described as accounting in units of general purchasing power or as accounting in units of current purchasing power.
>
> *Current cost accounting*. A method of measuring and reporting assets and expenses associated with the use or sale of assets, at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale.
>
> *Current cost/constant dollar accounting*. A method of accounting based on measures of current cost or lower recoverable amount in terms of dollars, each of which has the same general purchasing power.
>
> *Current cost/nominal dollar accounting*. A method of accounting based on measures of current cost or lower recoverable amount without restatement into units, each of which has the same general purchasing power.
>
> *Historical cost/constant dollar accounting*. A method of accounting based on measures of historical prices in dollars, each of which has the same general purchasing power.
>
> *Historical cost/nominal dollar accounting*. The generally accepted method of accounting, used in the primary

> financial statements, based on measures of historical prices in dollars without restatement into units, each of which has the same general purchasing power.

25. That is quite a daunting list, but I would divide the price-level alternatives into three categories:

    (a) Index approaches;

    (b) Direct-measurement approaches (usually current cost), and

    (c) Combinations of (a) and (b).

26. IAS 29 is an index-based standard, even if financial statements are prepared on a current-cost basis. In developing FAS 33, the FASB decided to require disclosure of information about both general and specific effects of price level changes.

27. The usual criticism of index-based approaches is that they ignore the effects of asset or liability-specific price changes. My first personal computer, an Apple II+, was purchased in 1980 cost about $2,500 in 1980 dollars. The Toshiba laptop on which I am drafting this paper is infinitely more capable and cost about $750 when I purchased it in April of this year. In his dissent to FAS 33, David Mosso observed:

> Mr. Mosso does not share the widely-held view that the historical cost/constant dollar and current cost models have different objectives. The objective is the same: To measure the effect of inflation on a business enterprise. But there are two types of inflation effect. The Board's historical cost/constant dollar model captures one type, the effect of inflation on the purchasing power of money invested in a particular business. The Board's current cost model captures both types. It incorporates some features of the constant dollar model and also the effect on the prices of goods and services that a particular business deals in. Inflation affects different specific prices in different ways. Consequently, information about changes in an index of general inflation does not provide sufficient information about the effect of inflation on a specific business enterprise. The current cost model is a more comprehensive inflation measurement approach and it

> makes a free standing historical cost/constant dollar model superfluous.

28. FASB member Ralph Walters disagreed. His dissent concluded with the following comment:

> The weight of evidence suggests that the Board is promulgating a current cost model that is not ready, for a constituency that is not ready for it. Experimentation with current cost and value information is sorely needed to establish their feasibility, reliability, cost, and usefulness. Mr. Walters believes that this experimentation should be conducted with volunteer companies working through professional organizations of business executives, accountants, and financial analysts. Regulators mandate experiments in financial reports; standard setters should not.

29. I suspect that some IASB constituents would argue that the comment is equally true today, 24 years later.

30. An index method has the advantage of simplicity in both application and explanation. Reduced to the most basic principles, it requires the multiplication of a number by a fraction. Some would no doubt argue that the simple method, even with its conceptual limitations, has a degree of objectivity that makes it superior to the alternative.

31. A full discussion of competing approaches is probably beyond the EEG's ability to pursue in a one-day discussion. I suggest then that we rephrase Question Two to ask where the IASB should *begin* its research. It will probably want to consider both approaches in developing a Discussion Paper, but an initial focus on one or another approach is useful.

The objective

Question Three: Assuming the IASB decides to pursue a project on price-level adjusted financial reporting, how does one describe the objective?

32. By now, EEG members may wonder why Question Three wasn't Question One. I delayed it until now because a discussion of *how* to do something often focuses attention on *why* it is done. I think there are at least two views on the objective:

33. View One – The objective is to present financial statements in a measurement unit that is current at the end of the reporting period. Proponents of View One might argue that usefulness is enhanced by presenting all assets and liabilities in a comparable measurement unit. Information about capital maintenance is a by-product of the exercise rather than an objective.

34. View Two – The objective is to present information about the effects of price-level changes on an entity's assets and liabilities. The resulting financial statements will present useful information about whether the entity is preserving, increasing, or depleting its capital base. Proponents of View Two might argue that conformity of the measurement base, while important, does not present the most useful information needed.

35. An IASB research project will want to pursue both objectives, but a show of support for each view (or others that EEG members might suggest) would be helpful information.

Some other topics

36. This section discusses several questions that occur in discussions of price-level adjusted financial reporting. EEG members' views on each would be useful in framing an IASB research project.

Who wants this information?

37. Most of the writing about price-level adjusted financial reporting is done by accounting standard setters and academics. I have found very little on the subject from the analyst community. As I recall the FASB discussions around the rescission of FAS 33, most analysts found the information confusing and pronounced it of little use. In fairness, that may be because FAS 33 required two approaches, neither of which was a usually presented as a complete application. By the time it went into effect, inflation in the US had already declined significantly.

Disclosure or restatement?

38. IAS 15 and FAS 33 were both disclosure standards. IAS 29 requires adjustments in the financial statements. Constituents often suggest that standard setters choose disclosure in notes rather than recognition in financial statements. There are several reasons for these requests. Disclosure in notes does not change on-going measurements in the financial statements and analysts' trend information. Some have suggested that information in notes is not prepared or audited with the same rigor (and thus cost) as information in the statements themselves.

39. Standard setters sometimes opt for disclosure as a first step in dealing with controversial or uncertain topics. The IASB has rejected this approach on several occasions since it began work in 2001.

40. The question here, as in all cases, is whether a disclosure solution would provide information that is as useful, and used, as adjustments in the carrying amounts of recognised assets and liabilities.

Reliable data?

41. When we discuss this topic in individual jurisdictions, IASB members and staff receive mixed reports on the quality of some government indices of inflation. The comments are always anecdotal and "off the record." The usual comment is something like this:

> The government says that our inflation rate was 10 percent last year. We know that the real figure is closer to 25 percent.

42. As I said, the comments are anecdotal and thus hard to substantiate. Still, they occur often enough to raise a concern. If the numerator in the indexing fraction is not reliable, then the result cannot be.

Where to put the credit?

43. IAS 29 requires that the "gain or loss on net monetary position" be presented as a single number in the current year's net income. The term is difficult to understand, but it refers to the sum of all the positive and negative adjustments required by the standard. This gives rise to two questions:

(a) Should the amount be presented as a single figure, or should the individual adjustments flow to the income statement categories connected with the underlying assets and liabilities?

(b) Should the amount be presented as a single figure, but in other comprehensive income? If so, should it be recycled and if so, how?

Unintended consequences?

44. I don't have anything in particular in mind here, but the unintended always occurs. Several jurisdictions have experience with price-level adjusted financial reporting and their experiences will be useful.

Is this trip necessary?

45. This is the last and most important question. Any move to wider application of price-level adjusted financial reporting will be difficult, costly and controversial. The IASB's research agenda includes 14 topics. Some of those, like business combinations under common control and foreign currency translation, have been the subject of previous EEG meetings. What Board members and staff take away from this meeting will definitely help them in forming a view. Based on all that has been covered in this meeting:

> Should the IASB actively pursue a research project on price-level adjusted financial reporting? If so, would EEG delegations be willing to participate in or lead the effort?