GPF meeting, March 2014
Agenda paper 7

Hyperinflation accounting and Venezuela

December 2013

NOVARTIS

Executive summary

- Applying IAS 29 for hyperinflationary economies is very challenging at both the local and consolidated financial statement levels and requires a lot of management judgment
- This is especially the case where the impact of hyperinflation is not offset by a corresponding reduction in the exchange rate as is the case in Venezuela.
- Groups applying IFRS need to follow the rules of IAS 29 and IAS 21 for the translation of the local financial statements which is considered to require the use of «official» exchange rates when producing their consolidated financial statements.
- As the following slides show, whilst IAS 29 may produce acceptable financial statements in the hyperinflationary economy, the current approach is considered to produce unacceptable distortions when applied for consolidation purposes. We therefore wish to ask the IASB to review the current approach for consolidated financial statements.
- Alternatives could be to make amendments to IAS 21 and IAS 29 to allow for consolidation purposes:
  - changes to the official FX rate for accounting and consolidation purposes (i.e. apply an FX rate based on the inflation differential between the local economy and that of the parent company rather than the actual FX rate).
  - Other methods such as USD reporting

NOVARTIS

Financial Reporting in Hyperinflationary Economies-IAS 29

- IAS 29 requires management to restate the local financial statements into current purchasing power at the end of the reporting period.
- According to the underlying capital maintenance model, profit is only earned if the net assets in units of constant purchasing power at the end of the period exceed the net assets at the beginning of the period after excluding any distributions to the shareholders.
- The application of IAS 29 requires judgment and reliance on external information such as general price indices.
- This is often done with the help of IT tools and local experts who are familiar with the statutory requirements of the country concerned.
- However, especially in Venezuela where there is an "official" fixed exchange rate, the application of IAS 29 in the accounts used for consolidation purposes in a group whose functional currency is not the currency of a hyperinflationary economy, produces distortions for the reasons mentioned on the following slides.

Novartis approach to accounting for Venezuela

- Novartis does not have production facilities in the country. The principal items sold are bought intercompany in USD.
- As a result, Novartis finances its Venezuelan operations not only with equity but also with intercompany USD payables but with no local debt.
- We apply IAS 29 locally and use the official exchange rate of 6.3 VEF/USD both local and consolidation purposes.
- Locally our customers are paying fairly promptly, but due to the severe exchange controls, we are building up large local cash balances and cannot pay off our intercompany payables in USD.
- This results in a large intercompany (and income statement) exchange exposure. We expect in the short term, with almost certainty ,a large devaluation and would ideally wish to make a provision but we cannot find a way to justify this under IAS 21 although we are now disclosing externally the amount of the exposure.
- Novartis has chosen the following approach for consolidating the balance sheets of its Venezuelan entities:
- The recoverable value of our net assets in the consolidation is represented by current assets and liabilities which are at current purchasing power values and if turned into cash would basically be worth their reported VEF value and if there were free convertibility at 6.3 to the USD we would realize and repatriate the values recorded in the consolidated balance sheet. In the consolidation, inventory is valued at the cost to the group excluding any unrealized intercompany profit-locally the value of the acquired intercompany inventory is used.
- Tangible fixed assets are worth more over time than initial cost so the current realizable value can be considered to be the inflation adjusted amounts-i.e on liquidation and repatriation at the rate of 6.3 to the USD it would be the inflation adjusted value which, assuming free convertibility, could be repatriated.
- We record the immaterial revaluation gain on the fixed assets into the income statement as also the higher depreciation on the inflated base goes into the income statement.

Novartis approach to Venezuela

- Novartis has chosen the following approach for consolidating the income statement of its Venezuelan subsidiaries:
- The income statement is inflation adjusted (Sales, Cogs and functional costs) but the result of these adjustments is reversed as a monetary loss within our financial result in the income statement. These adjustments are therefore income statement, net neutral.
- The only net impact in the income statement is the relatively immaterial impact of the hyperinflation accounting on the tangible fixed assets mentioned on the previous slide.
- It should be mentioned however that, due to the artificial «official» fixed exchange rate, there is internally an increasing concern and debate about the rationale for effectively inflating our sales and other income statement lines in USD terms in the consolidation as it is considered this does not appropriately reflect underlying business performance.

Back up

NOVARTIS

Issues related to the application of IAS 29 in consolidated accounts

- The inflation rate in a hyperinflationary economy and the deterioration of the FX rate are often not correlated. This can produce distortions in the consolidated accounts for a sustained period of time.
- In the consolidated financial statements eliminations are made such as:
  - intercompany items such as unrealized profits on inventory are deducted from the local inventory to calculate the consolidated inventory value
  - share capital/equity is eliminated against the investment of the holding company.
- However, these items are revalued locally in line with IAS 29. Such inflation adjustments should be zero in the consolidated accounts if inflation and devaluation go hand in hand. To the extent that this is not the case, the consolidated accounts show movements in the income statement which IAS 29 intended to eliminate based on the capital maintenance concept.
- Different accounting policies and accounting methods in the statutory accounts and in the accounts used for group reporting purposes also lead to differences in the monetary gain/losses which are difficult to understand and therefore hinder management performance information: e.g. cost of goods sold in the group accounts are calculated differently than in the statutory accounts (i.e. at standard costs + capitalized variances versus inventory at the beginning of the period + purchases – inventory at the end of the period).
- In conclusion, the local subsidiary can calculate the inflation adjustments for statutory accounts purposes but these adjustments are not always suitable to include in the group accounts.

NOVARTIS

IAS 29-Local accounting treatment

Balance Sheet

Restate all balances and comparatives to year-end current purchasing power

Do not restate monetary items

Do not restate inflation linked assets and liabilities

Do restate non-monetary assets. If revalued, restate from date of revaluation

Income Statement

All items to be expressed in terms of the measuring unit current at the balance sheet reporting date

NOVARTIS