

## STAFF PAPER

April 2015

## IASB Meeting

[this box can be used to give additional meeting dates]

<b>Project</b>	<b>High Inflation</b>
<b>Paper topic</b>	<b>Project recommendation</b>
CONTACT(S)	Alan Teixeira <a href="mailto:ateixeira@ifrs.org">ateixeira@ifrs.org</a> +44 (0)20 7246 6442

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

**Overview**

1. The purpose of this project is to consider the requests made by the Federación Argentina de Consejos Profesionales de Ciencias Económicas, the Argentinian standard-setter, and the Group of Latin American Standard Setters (GLASS) to:
  - (a) eliminate or reduce the cumulative inflation rate threshold currently included in IAS 29 *Financial reporting in Hyperinflationary Economies* to identify when hyperinflation exists; and
  - (b) to modify the procedures for reporting the adjustments resulting from restating the financial statements.
2. In the December 2014 meeting, ASAF members recommended that the IASB should consider a short-term project to review changing the threshold in IAS 29 to improve flexibility over when the accounting adjustments required by IAS 29 are applied. In addition, they suggested that a longer-term project could consider the accounting concepts for inflation accounting.
3. The purpose of this paper is to consider whether the IASB should develop a plan to work towards a revised or replaced IAS 29.
4. My recommendation is that the IASB should give this project a lower priority, and consider removing it from its work programme altogether.

## Background information

5. It is well understood that the financial position and performance of an entity can be affected by inflation. The IASB does not have a Standard that takes into consideration inflation generally. There is an IFRS (*IAS 29 Financial Reporting in Hyperinflationary Economies*) that overrides other IFRS when an entity is operating in a hyperinflationary economy, but it is designed to operate only with extreme levels of inflation.
6. IAS 29 does not establish an absolute rate at which hyperinflation is deemed to arise. Whether or not a country is considered to be experiencing hyperinflation will normally be determined on a country-wide basis, for example, by an agreement of the accounting profession, not by an individual entity. This is because it is preferable that all entities that report in the currency of the same hyperinflationary economy apply this Standard from the same date.
7. To identify whether a country has hyperinflation, IAS 29 requires an assessment of the following indicators:
  - (a) the general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency;
  - (b) amounts of local currency held are immediately invested to maintain purchasing power;
  - (c) the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency;
  - (d) prices may be quoted in that currency;
  - (e) sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;
  - (f) interest rates, wages and prices are linked to a price index; and
  - (g) the cumulative inflation rate over three years is approaching, or exceeds, 100 per cent.
8. The last of the indicators, (g), seems to gain more attention than the other indicators, perhaps because it is a quantitative threshold. The IASB has been asked to consider a request to change the definition of hyperinflation so that 8 per cent per annum over a three-year period (ie cumulatively 26 per cent) would indicate hyperinflation.

9. This request has come from some stakeholders who are concerned that the financial position and performance of entities is being distorted in countries subject to medium- or long-term high inflation levels. The requests relate mainly to the Latin America region, but are equally applicable to entities in other high-inflation countries.

### **Requests to the IASB**

10. Several bodies have provided the IASB with thoughtful and helpful analysis of the issues facing countries with high inflation.

#### ***Latin America (2010)***

11. In 2010, at the request of the IASB, a group of Latin American standard-setters began looking at issues related to ‘high’ inflation. That led, in September 2010, to the Federación Argentina de Consejos Profesionales de Ciencias Económicas (the Federation), the Argentinian standard-setter, writing to the IASB requesting the IASB to consider a proposal to replace IAS 29.<sup>1</sup> The Federation attached the draft of a new Standard that it considered would put IFRS “in a position to provide an adequate answer to the effects of inflation on financial reporting.”<sup>2</sup> In its letter the Federation states that

‘It is a basic accounting principle that all measurements must be made by using the same measurement unit. It is also a basic principle, an implicit but an obvious one, that the measurement unit, i.e. the currency, must have a constant value over time.’

12. The Federation believes that when financial statements are not adjusted for inflation, the comparisons and aggregations do not provide adequate information.

---

<sup>1</sup> The Federation acknowledged the contributions from the standard-setters from Brazil, Mexico and Chile. The letter pre-dates the establishment of GLASS.

<sup>2</sup> Accompanying letter from the Federación Argentina de Consejos Profesionales de Ciencias Económicas. September 2010, accessible on the IASB website at <http://www.ifrs.org/Meetings/Pages/EEG-meeting-December-2013.aspx>—see also the References section at the end of this paper.

The Federation presented a research paper in the form of a draft Standard, which proposed a replacement for IAS 29, except that rather than applying only to hyperinflationary economies it was a general inflation standard.

13. The Federation was concerned that IFRSs do not produce quality information in those countries suffering from high inflation. They believe that from a conceptual viewpoint, restatements should be performed whenever the effects of inflation are significant. Most of the Commission members considered that such decisions would involve a drastic change in accounting practices, particularly for countries without an inflationary track record.
  
14. If the inflation levels are not significant enough, the restated financial statements do not necessarily provide better information than those that were not restated. Besides generating costs that cannot exceed benefits, if the economic environment is below certain levels of inflation, the adjustment may introduce a factor that can impair the interpretation of the financial statements. As a result, it has been considered that the inflation restatement shall be required if specific, and relatively high, levels of inflation are reached. Accordingly, the Federation proposed that this new Standard should be applied when:
  - (a) the cumulative inflation rate of its functional currency for the last 12 months is higher or equal to 10 per cent; or
  - (b) the cumulative inflation rate of its functional currency for the last 36 months is higher or equal to 26 per cent; or
  - (c) the preceding financial statements were restated and the cumulative inflation rate of its functional currency has not been lower than 15 per cent for the last 36 months.

***IASB Emerging Economies Group (2013)***

15. The IASB's emerging economies group discussed inflation accounting as its main topic at the December 2013 meeting.
  
16. At that meeting GLASS asserted that jurisdictions that have suffered from hyperinflation, although (fortunately) they are not suffering from it at present, may still experience annual inflation and have a widespread perception that financial

statements that ignore inflation approaching 10 per cent or more, in the long run may mislead users and undermine year-to-year comparisons.<sup>3</sup>

17. At the time, only one country in Latin America qualified as a hyperinflationary economy—Venezuela; while several countries in Latin America have inflationary economies. GLASS therefore suggested that the IASB should:
  - (a) remove the 100 per cent hyperinflation threshold presented under characteristics of a hyperinflationary economy;
  - (b) allow inflation accounting for entities whose functional currency is not the currency of a hyperinflationary economy, but whose primary users of the financial statements consider the loss of that currency’s purchasing power to be relevant over a specified period; and
  - (c) enhance the procedures for restatement of financial statements.
18. GLASS acknowledged that this would involve a comprehensive new project.

### **ASAF (2014)**

19. GLASS presented a paper to the Accounting Standards Advisory Forum (ASAF) in December 2014, considering some of the problems with the existing requirements of IAS 29 and how the Standard could be improved. The paper recommended that the ‘trigger’ for the application of IAS 29 should be lowered to 26 per cent over three years (ie 8 per cent per annum). This threshold was the same as that proposed by the Federación Argentina de Consejos Profesionales de Ciencias Económicas, but the GLASS recommendation was to lower the threshold for IAS 29 rather than proposing a new general inflation Standard. The Brazilian standard-setter thinks that general price level adjustments should be required for entities in **high-inflation** economies, not merely those in hyperinflation.
20. At the meeting, some ASAF members thought that a 100 per cent threshold was ‘unrealistic’. However, there was mixed reaction on whether opening up IAS 29 was the right answer or whether we should instead change the accounting basis for

---

<sup>3</sup> The letter from the Federación Argentina de Consejos Profesionales de Ciencias Económicas was sent to the IASB before the constitution of GLASS and was not discussed by GLASS.

everyone. There was some support for a long-term solution as part of the *Conceptual Framework* project.

### **Other—CMAC**

21. Recently the CMAC, the Global Preparers Forum and the IFRS Interpretations Committee have considered restrictions associated with official currency rates in Venezuela. Currency restrictions are sometimes associated with high-inflation economies.
22. At the Global Preparers Forum meeting in March 2014, during the discussion about hyperinflation, a concern was raised about the requirement to consolidate foreign subsidiaries using the ‘official’ foreign exchange rate, in cases in which that rate may not reflect the market value, such as in economies that are facing high or hyperinflation. This is considered to have resulted in financial performance in some subsidiaries appearing at values that are artificially inflated—for example revenues and expenses are consolidated at inflated amounts because of the artificial currency.
23. This is not strictly a hyperinflation issue. What it does highlight is that if the exchange rates in Venezuela were at their market levels, the translation of the Venezuelan subsidiary into another functional currency would not simply be ‘distorted’ by the hyperinflation. The related fall in the value of the currency would offset a significant portion of the hyperinflationary effect.
24. I think these matters are valid concerns raised by CMAC members, but lowering the threshold for IAS 29 will not resolve them.

### **Investors**

25. I have not undertaken a systematic consultation with investors. However, we did discuss the topic with the CMAC at its meeting in February 2015. The strong and consistent message from CMAC members was that the IASB should not lower the indicative threshold. Among the comments expressed were:

- (a) Lowering the threshold would put a lot of pressure on the credibility of the particular price index used, because most countries will have experienced this level of inflation, or something close to it, in the last 20 years.
  - (b) IAS 29 is a very blunt instrument that is trying to fundamentally correct a major economic event in a country and lowering the threshold without considering the Standard more carefully would be dangerous.
  - (c) Analysts cope with price changes and that is one of their roles.
  - (d) Adjusting prices as if the price changes had not occurred is like adjusting for a very high fever and pretending it is normal. The adjustments can make it difficult to assess the true financial health of the company and hide economic reality.
26. There was also a general discussion about the effects of inflation, particularly in countries with exchange controls that caused counterintuitive results. Again, CMAC members thought that IAS 29 should only be used when it was obvious that a country was going through a major economic readjustment and the currency is, effectively, irrelevant—the test must be very high.
27. In summary, there was no support from CMAC members for lowering the indicative threshold.

## **Data**

28. I analysed inflation data from 1970 to 2013 using information provided by the World Bank. The analysis, set out in the appendix to this paper, shows that if the threshold had been 8 per cent (ie 26 per cent over three years), IAS 29 would clearly have been applied far more frequently, and by entities in virtually all jurisdictions, than would have been the case using the current definition of hyperinflation.
29. The extent of its application would, in my view, change the character of IAS 29 from a hyperinflation Standard to a more general inflation Standard that regularly adjusts amounts for price level changes. The IASB would need to be confident that IAS 29 provided sensible accounting for these lower-inflation circumstances.

### Is IAS 29 a good Standard?

30. IAS 29 is a general price-level Standard that requires that amounts reported by an entity be adjusted by a general price index. The Standard provides some guidance on identifying a price index and which items to convert. In my opinion, the Standard is relatively blunt instrument for dealing with price changes. It does not set out a capital maintenance objective and the measurement basis is focused on adjusting other measures into amounts that reflect the large changes in prices.
31. Those familiar with the different capital maintenance and price adjustment models that have been developed by Standard-setters will know that IAS 29 does not attempt to address many of the issues necessary for a comprehensive “inflation” Standard. This is not a criticism of IAS 29. It is a Standard that is designed to step in and provide low cost adjustments to financial statements when an economy is no longer functioning normally. IAS 29 does not, for example, attempt to identify or separate holding gains on traded assets or define a capital maintenance concept. It simply sets out adjustments that entities need to make when faced with hyperinflation.

### Is there a case for IFRS to adjust for ‘inflation’?

32. If the IASB is to develop requirements, it will need to undertake a more comprehensive project than simply applying an index to transaction-based numbers.
33. At the heart of the issue is determining how to measure ‘profit’, which is generally measured as the increase in equity of an entity, excluding transactions with the owners, over the capital (equity) being maintained. In IFRS today the equity being maintained is the ‘number of currency units’.<sup>4</sup> For IFRS, this simply means that comprehensive income is any excess over the number of currency units of equity held at the beginning of the year.
34. Different concepts of capital maintenance would lead to different amounts of comprehensive income. Over the last 40 years or so, the merits of many capital

---

<sup>4</sup> This is commonly referred to as NOD or number of dollars in the literature, because it appears mainly in US journals.



maintenance schemes have been debated, and in some cases they have led to Accounting Standards in different jurisdictions. They have included accounting designed to maintain capital at a level that reflects:

- (a) general price levels (ie general inflation within a jurisdiction);
- (b) specific price changes that are relevant to an entity, reflecting the specific assets it holds and the price changes to which it is exposed;
- (c) the physical capability or capacity of the entity;
- (d) the ability to replace its existing assets; and
- (e) the ability to adapt by selling its assets.

35. A complete system requires decisions about what capital it is trying to maintain, the measurement attributes for specific assets (ie how to re-measure assets) and how to account for those changes. Some systems separate the holding gains (such as the change in value of inventory that has occurred because of price changes being separated from the selling price to identify the ‘real’ gain). Some systems also make working capital adjustments on the basis that an entity will need more working capital during times of rising prices.
36. As I mentioned earlier, there have been several standard-setting efforts to develop financial reporting standards that involve some sort of price adjustments and capital maintenance. The American Institute of CPAs published Accounting Research Study No 6, *Reporting the Financial Effect of Price-Level Changes* in 1963. In 1969, the Accounting Principles Board issued APB 3 *Financial Statements Restated for General Price-Level Changes*. In 1982 the NZ standard-setter issued CCA 1 (Current Cost Accounting 1). It was withdrawn in 1986.
37. In 1977, the IASC issued IAS 6 *Accounting Responses to Changing Prices*, replacing it in 1981 with IAS 15 *Information Reflecting the Effects of Changing Prices*. IAS 15 was withdrawn by the IASB in 2003. The FASB issued FAS 33 *Financial Reporting and Changing Prices in 1979*, withdrawing it in 1986. The UK standard-setter issued SSAP 16 *Current Cost Accounting* in 1985. It was withdrawn in 1988.

38. None of these Standards were mandated and none has survived. There was also very little voluntary uptake. For example, only three companies applied CCA 1 in New Zealand, and there is some evidence that the adopters had political incentives to do so.
39. This paper does not set out to provide a comprehensive history of accounting standards that make price level adjustments, nor to provide a complete history of the literature on capital maintenance. However, I do want to emphasise two points. The first is that discussions about ‘inflation accounting’ should involve more than simply considering whether to adjust recorded transactions by a general price index. The second is that price and capital maintenance adjustments add complexity to financial reporting for preparers and users.

## Summary

40. IAS 29 is a Standard that requires simple adjustments to amounts presented by entities in countries suffering from hyperinflation. It is not designed to be a general price-level Standard.
41. Developing a Standard that takes into account price-level changes would require a fundamental project that includes an assessment of an appropriate capital maintenance model. Attempts to do so over the last 40 years in developed economies have systematically failed, even during periods of high inflation. Such standards impose high costs on preparers and add significant complexity to the financial reports.
42. As CMAC members noted, within a country suffering hyperinflation all entities will be affected by hyperinflation and are therefore “comparable”. Investors and analysts have been coping with the problem of inflation for decades.
43. I think that there is a low probability that any research will lead to specific proposals to either significantly change the accounting model in IAS 29 or for an IFRS that addresses price changes. On this basis I consider that the cost-benefit payoff for the IASB and the IFRS community would be low and the IASB should remove the project from its active agenda.

44. The appropriate place for considering this issue is within a future phase of the Conceptual Framework project.

### Recommendation

I recommend that the IASB should give this subject a lower priority, and consider removing it from the research agenda altogether, for the following reasons:

broadening the application of IAS 29 is not appropriate because it is not a general price-level Standard;

the issue of inflation accounting is a broad and fundamental issue that is best considered in the *Conceptual Framework* project, because it should be considered in conjunction with capital maintenance concepts—and several attempts to mandate price-level standards in developed economies have not been successful ; and

issues related to currency restrictions can be more effectively addressed at the Implementation level.

## References

The papers referred to in this paper are available on the IFRS website as papers discussed at the December 2013 meeting of the Emerging Economies Group.

<http://www.ifrs.org/Meetings/Pages/EEG-meeting-December-2013.aspx>

Paper reference on IFRS website	Description
AP 1A: Discussion Guide	A paper written by Wayne Upton for the EEG meeting on price-level adjusted financial statements.
AP 1B: Discussion Guide Appendix 1	The letter from the Federación Argentina de Consejos Profesionales de Ciencias Económicas, the Argentinian standard-setter, to the IASB requesting the IASB to consider a proposal to replace IAS 29.
AP 1C: Discussion Guide Appendix 2	A research paper from Federación Argentina de Consejos Profesionales de Ciencias Económicas in the form of a draft Standard on <i>Inflation</i> .
AP 1D: IAS 29 Financial Reporting in Hyperinflationary Economies Applicability of the concept of financial capital maintenance defined in constant purchasing power units	A staff paper discussed at the IFRS Interpretations Committee in September 2013, considering whether an entity is permitted to use the financial capital maintenance concept defined in terms of constant purchasing power units when the entity's functional currency is not the currency of a hyperinflationary economy as described in IAS 29 <i>Financial Reporting in Hyperinflationary Economies</i> .
AP 1E: Agenda for the papers	This is the meeting agenda for the EEG meeting in December 2013.
AP 1F: Inflation in the World—IMF	
AP 1G: Adjusted for Ticket price inflation—link to a website	
AP 1H: Performance adjusted by inflation effects—slide presentation	





