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Inflation effect on Equity

Normally, in high inflation environments, most of the effort to correct the financial figures to show the effect of inflation on the financial information, it is set in the restatement of assets and liabilities, but the impact on the figures inside Equity have to be understood and properly correct to present financial information of high quality.

The two conceptual components of equity are:

1. Proprietors contributions
2. Accumulated results

The financial capital maintenance concept gives us the proper solution to the adequate distribution of the amounts between both concepts. The following is the transcription of the concepts of the ED Conceptual Framework for Financial Reporting issued in May 2015:

(a) Financial capital maintenance. *Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners holders of equity claims during the period. Financial capital maintenance can be measured in either nominal monetary units* ***or units of constant purchasing power.***

The measure of the amounts of owners holders of equity must be made in constant purchasing power units when inflation is high, because the distortion of not doing so produce an inappropriate measurement of benefits even correcting previously the measurement of assets and liabilities.

To obtain a true and fair measurement of the owners accumulated contributions to the entity equity, we have to consider in each period the accumulated contribution at the beginning of the period plus the new contributions made during the period less the distributions made to the owners during the measurement period.

Of course, all this measurements have to be made at the equivalent constant purchasing power of the period closing date.

Example:

Concepts	**Nominal Amounts**	**Restated Amounts**
20X1		
Monetary Assets	12.000	12.000
Non Monetary Assets	16.000	28.000
Monetary Liabilities	(4.000)	(4.000)
Equity	24.000	36.000
Owners contributions	5.600	17.600
Accumulated profit (loss)	18.400	18.400

Concepts	Nominal Amounts	Restated Amounts
20X2		
Monetary Assets	23.200	23.200
Non Monetary Assets	18.500	30.362
Monetary Liabilities	(2.800)	(2.800)
Equity	38.900	50.762
Owners contributions	5.400	25.117
Accumulated profit (loss)	33.500	25.645
Contributions June 20X2	1.000	1.151
Distributions March 20X2	(1.200)	(1.554)
Profit (loss) of the period	16.300	8.798

Non Monetary Assets		
Concepts	**Nominal Amounts**	**Restated Amounts**
Initial amount	16.000	28.000
Increases	3.550	4.085
Depreciation	(1.050)	(1.723)
Final amount	18.500	30.362

Price Index	
December 20X1	100
March 20X2	112
June 20X2	126
December 20X2	145

As profit is defined in the conceptual framework as the difference between the changes in the amount of Equity and the changes in the amount of accumulates Owners contributions, not restating the amounts of owners contributions leave the differences as profit, what is clearly incorrect because in an environment of high inflation, the nominal values of the owners contributions are very much less than the amount really contributed by them measured at it purchasing power value, and therefore the entities can distribute dividends making the equity decrease in restated values.

In other words, the reference for dividends and taxes will be severely distorted allowing the distribution of amounts clearly incorrect. As can be seen in the example, the profit for the period according with not restated amounts ($ 16.300.-) is very different for the one determined according with restated figures ($ 8.798.-) and therefore all the performances indicators will be misleading.