August 31, 2015

Reference: Comments on Agenda Paper 14, *Inflation Project*

Some time ago Argentina and Mexico joined forces to study the topic of inflation accounting, based on the experiences that both countries have with inflationary economic environments. The two countries have formed a working group (WG) to propose changes to IAS 29.

In response to the most recent communication on the topic of inflation accounting sent to the IASB by GLASS, the IASB issued Agenda Paper 14, on which we present the following analysis made by the WG:

Inflation indicates a general increase in prices, which represents a cost for those that operate in an environment in which the phenomenon is present. As a result, not recognizing the effects of inflation in financial statements distorts the information presented, resulting in a situation that could lead to incorrect decision making.

For example, when reporting the results of a period that do not include the costs of inflation, and such results are distributed to shareholders as dividends, the risk of decapitalization is created, which, depending on the significance of the effects, could lead to the insolvency or bankruptcy of an entity.

Several Latin American countries have experienced unstable economic environments for several years, and it has been observed that annual inflation rates of between 5% and 10% result in a significant increase in the costs of the economic environment. Further, because it is cumulative, after even a brief period, the cumulative three-year inflation could exceed 30%. As a result, it becomes essential to recognize the increases in costs in the financial statements and to distinguish which portion of the changes in equity during a specific period correspond to the compensation of the loss in value of the currency and which portion corresponds to real growth that, therefore, could be available for distribution to shareholders without adverse consequences.

Based on studies carried out by some Latin American countries, they have been able to conclude that cumulative three-year inflation of 26% is normally a good indicator that the effects of inflation should be recognized in the financial statements to avoid the risk of decapitalization.

The responsibility of accounting standard setters is to develop standards that result in the generation of reliable financial information to allow adequate decision making. Based on this principle on various occasions we have sent communications to the IASB with proposals to address inflation accounting.

With respect to the aforementioned communication sent to the IASB by GLASS, as well as to the presentation made by its representative in ASAF, we are aware of the outline of the presentation of our communication made to the IASB Board by the Senior Director of Technical Activities, Alan Teixeira, in Agenda Paper 14 of the

IASB meeting held on April 29, 2015, which, we carefully analyze, detail and discuss below[1]:

1. ***The requests of GLASS are: a) to eliminate or reduce the cumulative inflation rate threshold currently included in IAS 29 to identify when hyperinflation exists; and b) to modify the procedures for reporting the adjustments resulting from restating the financial statements.***

<u>*WG comment*</u>

a) eliminate or reduce the cumulative inflation rate threshold:

As previously mentioned, based on studies carried out by some Latin American countries, they have been able to conclude that cumulative three-year inflation of 26% is usually a good indicator that the effects of inflation should be recognized in the financial statements to avoid the risk of decapitalization.

We believe it is necessary to establish qualitative criteria to classify an economic environment as inflationary.

The conclusions of the studies indicate that when comparing financial ratios based on figures without any recognition of inflation to those based on figures with recognition of inflation, the results begin to be very different when cumulative three-year inflation is around 26%, which represents an average annual inflation of 8%.

b) modify the procedures for reporting inflation adjustments in financial statements

In general, we agree with the methodology established in IAS 29; however, we believe that recognition of the effects of inflation in financial statements should be comprehensive, and we have proposed some minor modifications to the methodology in IAS 29.

2. ***The request comes from some stakeholders who are concerned that the financial position and performance of entities is being distorted in countries experiencing medium or long-term high levels of inflation.***

<u>*WG comment*</u>

The request comes the Group of Latin American Accounting Standard Setters (GLASS), which brings together 17 of the more significant standard setters in Latin America.

One of the tasks of GLASS is to communicate to the IASB the needs of the region with respect to accounting standards. As a result, instead of being just a group of interested parties that communicates concerns to the IASB, GLASS is a body that represents Latin America.

[1] To facilitate comprehension and understanding, we have copied extracts of the outline of the IASB meeting in bold text. The opinion of GLASS is presented immediately following each topic.

3. ***Lowering the threshold in IAS 29 would not be a solution because IAS 29 was to be applied in very extreme cases, i.e., with hyperinflation and not just high inflation.***

   WG comment

   Precisely what is being requested of the IASB is that it reconsider the need to lower the trigger for the application of IAS 29 such that the standard apply when an environment is inflationary and not wait until it is hyperinflationary, as currently established by IAS 29. As previously mentioned, the rate of inflation is not the only element to define an environment as inflationary.

   The experience of Latin American countries tells us that with double-digit inflation there are risks with making decisions on financial statements that do not include such effects; waiting until hyperinflation is reached implies waiting until the financial statement problem is acute.

4. ***IAS 29 was a very blunt instrument that was trying to fundamentally correct a major economic event in a country, and lowering the threshold without considering the Standard more carefully would be dangerous.***

   WG comment

   The WG's proposal does not only pretend to reduce the inflation rate threshold, as we agree that it will be necessary to carefully consider the other factors that trigger the requirement to recognize the effects of inflation in financial statements.

   Inflation currently impacts various countries, especially those of emerging economies; in most of them it has been concluded that it is best not to wait until hyperinflation is reached and to recognize the effects of inflation when annual inflation approaches double digits; deferring its recognition can lead to severe decapitalization.

5. **One proposal is to require specific disclosures in entities operating in high inflation environments.**

   WG comment

   We believe that disclosure of the effects of inflation by itself is not only insufficient, but it also can create confusion and distrust in financial statement users, since they would present figures in the basic financial statements and the notes to such financial statements would provide information with differences that could be significant.

   Inflation represents a cost for entities that should be recognized in the results of the period; to do otherwise skews the basis the declaration of dividends by increasing it and causing decapitalization. As a result, we believe that disclosures alone are insufficient.

Additionally, only including disclosures can result in confusion because they would show a result of the period that differs from that presented in the basic financial statements; logically, this would also cause a lack of trust in the financial statements.

6. **Another alternative solution is to only revalue property, plant and equipment.**

WG comment

Inflation affects all categories of the financial structure of an entity; in addition to property, plant and equipment, it affects inventories, intangible assets and equity, plus generating a holding loss on monetary items, which directly impacts the results of the entity.

Consequently, only revaluing property, plant and equipment is insufficient, since the comprehensive effects of inflation should be recognized.

7. **The inflation accounting project has been removed from the IFRSIC agenda since currently it is believed that there is no clear practical solution for the modification of IAS 29, and as a result any modification would be in the long term.**

WG comment

The WG is aware that the topic of inflation accounting requires in-depth analysis before making any changes to IAS 29 and, being a long-term project, may not fall within the scope of the IFRSIC agenda.

Accordingly, the WG requests that the IASB open a space in its agenda to study the topic of inflation accounting with the depth and time required; we believe that the decision to decide whether this topic should be retained or dropped from the IASB agenda should be made based on sustained and solid technical arguments.

If you require more information or clarification about the contents of the letter, you can count on us to provide you with anything you may need.

Sincerely,

Domingo Marchese Argentine Federation of Professional Boards of Economic Science	Felipe Pérez Cervantes President of the Mexican Financial Reporting Standards Board