STAFF PAPER

10–11 September 2013

IFRS Interpretations Committee Meeting

Project	**IAS 29 *Financial Reporting in Hyperinflationary Economies***		
Paper topic	Applicability of the concept of financial capital maintenance defined in constant purchasing power units		
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Introduction

1. In September 2012 the IFRS Interpretations Committee (‘the Interpretations Committee’) received a request to clarify:

   (a) 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 *Financial Reporting in Hyperinflationary Economies*; and

   (b) whether the entity needs to apply IAS 29 to its financial statements prepared under that concept of financial capital maintenance when it falls within the scope of IAS 29.

2. More specifically, the submitter is asking the Interpretations Committee to clarify that IAS 29 is not applicable if financial statements are prepared under a specific model of a financial capital maintenance concept that is defined in constant purchasing power units, such as the model that is referred to in the submission.

3. The objective of this Agenda Paper is to provide the Interpretations Committee with the background to the issues and the staff’s research and analysis. This Agenda Paper also contains two questions to the Interpretations Committee.

4. This Agenda Paper is structured as follows:

(a) background information on the issue;

(b) staff technical analysis;

(c) summary of the result of outreach;

(d) agenda criteria assessment;

(e) staff recommendation;

(f) questions for the Interpretations Committee;

(g) Appendix A—Proposed wording for tentative agenda decision;

(h) Appendix B—Extract of submission; and

(i) Appendix C—The submitter's commentary on a proposal for amendments to IAS 29.

Background

5. In the submission, the submitter refers to a proposal for amendments to IAS 29, which was submitted to the IASB in 2010 by the Argentinian standard-setter, the Federación Argentina de Consejos Profesionales de Ciencias Económicas. The submitter has prepared a commentary on the Argentinian proposals as well as his own proposed amendments to those proposals. In that commentary, the submitter describes his own view on financial capital maintenance in units of constant purchasing power (hereinafter we call the submitter's model the 'CMUCPP').

6. On the basis of our discussions with the submitter, we understand that the main differences between financial statements prepared using IAS 29 and those prepared using the CMUCPP are:

(a) the scope of monetary items; for example, trade receivables and payables. These are classified as monetary items under IAS 29 but are classified as non-monetary items under the CMUCPP. This difference gives rise to a difference in the amount of net monetary gain or loss. This is because, under both the CMUCPP and IAS 29, non-monetary items are restated with changes in the carrying amounts being

recognised as monetary gain or loss while monetary items are not restated; and

(b) different requirements for the adjustment of amounts in the financial statements in accordance with a general price index. Under the CMUCPP, amounts in the financial statements are adjusted for changes in a general price index even after a reporting date.[1] That is, the amounts in the financial statements as of the reporting date are continuously updated to the current date on a daily basis after the reporting date.

7. The submitter asks whether, under IFRS, an entity is permitted to prepare financial statements using the concept of financial capital maintenance defined in constant purchasing power units in a non-hyperinflationary situation. Those supporting this view refer to the *Conceptual Framework*, which describes that concept of financial capital maintenance as one of the capital maintenance concepts that are used in an entity's financial statements (paragraph 4.59(a)).

8. In addition, the submitter thinks that IAS 29 would not be applicable if the financial statements are prepared under the concept of financial capital maintenance defined in terms of constant purchasing power units, including the CMUCPP. This is because all items in such financial statements would already be restated for changes in a general price level. In our discussions with the submitter, the submitter also stated that it would be impossible and unnecessary to restate by applying the requirements in IAS 29 amounts in financial statements prepared under the CMUCPP. This is because financial statements prepared under the CMUCPP are stated in the most recent purchasing power while the measuring unit under IAS 29 represents a purchasing power in the past (ie the reporting date).

9. The original submission and the commentary prepared by the submitter are reproduced in Appendix B and Appendix C to this Agenda Paper, respectively.

10. Accordingly, this Agenda Paper contains our analysis on the two issues:

[1] URV (Unidade Real de Valor)-based Daily Index is used under the CMUCPP as stated in Appendix C to this Agenda Paper.

Issue 1: whether an entity whose functional currency is **not** the currency of a hyperinflationary economy is permitted to use the financial capital maintenance concept that is defined in constant purchasing power units when preparing IFRS financial statements.

Issue 2: whether IAS 29 is applicable to an entity whose functional currency is the currency of a hyperinflationary economy if its financial statements have been prepared under a specific model of a financial capital maintenance concept that is defined in constant purchasing power units.

Staff technical analysis

Issue 1—whether an entity is permitted to use constant purchasing power units in a non-hyperinflationary situation

11. In our discussions, we found that there could be three alternative views on this issue, as follows:

View 1: IFRSs provide an entity with no ability to use any model of the financial capital maintenance concept defined in constant purchasing power units

12. Those who support this view argue that when preparing financial statements in accordance with IFRS, the entity should apply an IFRS that specifically applies to a transaction, other event or condition (paragraph 7 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors).* IFRSs are written from the perspective of an entity using the concept of financial capital maintenance that is defined in terms of nominal monetary units. An entity has no ability to depart from the requirements in each IFRS if the IFRS is applicable.

13. For example, IAS 38 *Intangible Assets* requires an entity to subsequently measure an intangible asset at its cost less any accumulated amortisation and any accumulated impairment losses if the cost model is chosen (paragraph 74 of IAS 38). Remeasurement of the carrying amount of the intangible asset in terms of the measuring unit current at the reporting date, which would be required by the financial capital maintenance concept defined in constant purchasing power units, would result in a departure from the requirements for subsequent measurement of an intangible asset in IAS 38.

View 2: The Conceptual Framework permits an entity to select a specific model of the financial capital maintenance concept defined in constant purchasing power units if certain conditions are met

14. Those who support this view note that the selection of the capital maintenance concept is a choice that is available within the *Conceptual Framework* that provides a fundamental basis of preparation of financial statements. Paragraph 4.58 of the *Conceptual Framework* states that "the selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements". Accordingly, those who support this view argue that the entity is permitted to use the financial capital maintenance concept defined in constant purchasing power units if this concept, among the alternative concepts described in the *Conceptual Framework*, provides the most useful information to users.

15. Having made a choice of using the financial capital maintenance concept in constant purchasing power units, the entity would develop accounting policies by referring to an IFRS that addresses a transaction, other event or condition analysed in accordance with paragraph 10 of IAS 8. The entity would need to adapt each IFRS for the use under that capital maintenance concept because all IFRSs are written to be applied using nominal monetary units in a non-hyperinflationary situation.

View 3: The Conceptual Framework permits an entity to select the financial capital maintenance concept defined in constant purchasing power units if certain conditions are met, but should apply IAS 29 by analogy

16. Those who support this view also think that the *Conceptual Framework* permits an entity to select the financial capital maintenance concept that is defined in constant purchasing power units if such a capital maintenance concept best meets the needs of users. However, they think that the entity should use the accounting model described in IAS 29, by analogy, in accordance with paragraph 11 of IAS 8. They note that although the requirements in IAS 29 are only mandatory for entities reporting in a hyperinflationary currency, in their view, IAS 29 deals with a similar condition.

17. Accordingly they think that if a financial capital maintenance model defined in a measuring unit current at the reporting date is applied when preparing IFRS financial statements, that model should be the one described in IAS 29.

Staff's view

18. We note that when preparing IFRS financial statements, an entity is required to apply applicable IFRSs. Paragraph 7 of IAS 8 states:

> **7 When an IFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS.**

19. We think that the measurement of financial statements items on the basis of the measuring unit current at the end of the reporting period would result in a measurement that is contrary to the requirements of other IFRSs (except for IAS 29). For example, IAS 38 *Intangible Assets* states:

> **8 The following terms are used in this Standard with the meanings specified:**
>
> …
>
> (a) *Cost* is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment.*

Cost model

> **74 After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses.**

20. We think that applying a model under financial capital maintenance defined in constant purchasing power units to an intangible asset would result in subsequently remeasuring that item from cost to a restated amount, which is inconsistent with the requirements in paragraph 74 of IAS 38. The amount of the cost adjusted for changes in a general price level would not represent the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction as stated in paragraph

8 of IAS 38. We also note that other IFRSs such as IAS 2 *Inventories* and IAS 16 *Property, Plant and Equipment* define or describe the term 'cost' in similar ways.

21. In IFRS financial statements, an entity is required to apply IFRSs such as IAS 2, IAS 16, and IAS 38 to measure inventories, items of property, plant and equipment, and intangible assets. The entity is unable to depart from the requirements in applicable IFRSs unless expressly permitted or required by an IFRS that addresses a specific situation such as a hyperinflationary situation described in IAS 29. In this regard, IAS 29 is applicable only in a specific situation in which the conditions set out in IAS 29 are met (ie only when the entity's functional currency is the currency of a hyperinflationary economy).

22. As stated above, we think that IFRSs dictate measurement of items in financial statements in both a hyperinflationary situation and a non-hyperinflationary situation. The *Conceptual Framework* does not override the requirements in IFRSs (Introduction section of the *Conceptual Framework*).

23. Consequently, we are of the view that IFRSs prohibit an entity from preparing its financial statements under the concept of financial capital maintenance defined in constant purchasing power units unless the entity falls within the scope of IAS 29.

Issue 2—whether IAS 29 applies to an entity whose functional currency is the currency of a hyperinflationary economy if its financial statements have been prepared under a specific model of a financial capital maintenance concept that is defined in constant purchasing power units.

24. As discussed in Issue 1 above, we are of the view that IFRSs do not provide an entity with an ability to use the financial capital maintenance defined in constant purchasing power units unless IAS 29 applies. In this sense, this issue may no longer be relevant. However, as stated above, we note that IAS 29 requires an entity to apply IAS 29 if the entity's functional currency is the currency of a hyperinflationary economy. That IFRS does not permit the entity to depart from the requirements in IAS 29 when the conditions in IAS 29 are met.

25. Accordingly, we are of the view that an entity is not permitted to use a model that is different from a model in IAS 29 in IFRS financial statements if the entity meets the conditions set out in IAS 29.

Summary of the results of outreach

26. In order to gather information about the issue described in the submission, we sent requests to the International Forum of Accounting Standard-Setters (IFASS) and regulators. Specifically, we asked:

    (a) In your jurisdiction, are you aware of any entities that prepare or are trying to prepare financial statements using any type of constant purchasing power units, whether or not the currency of those financial statements is the currency of a hyperinflationary economy?

    (b) If you answered 'yes' to question 1:

        (i) what is the prevalent basis of accounting for preparing such financial statements?

        (ii) if the functional currency of such financial statements is the currency of a hyperinflationary economy, do entities apply or plan to apply IAS 29 to the financial statements stated in terms of a constant purchasing power unit? If possible, could you please briefly describe the rationale for that accounting?

    (c) If it is common in your jurisdiction for financial statements to be prepared with a functional currency that is the currency of a hyperinflationary economy, to what extent do you observe diversity in practice in the way in which those financial statements are prepared? Please describe the approaches you observe.

27. We have received 12 responses to the request. The views expressed below are informal opinions from national standard-setters and regulators. They do not reflect the formal views of those organisations. The geographical breakdown of the responses is as follows:

Geographical area	Number of respondents
Worldwide	1
Americas	3

Asia/Oceania	2
Africa	1
Europe	5
Total respondents	**12**

28. No respondents stated that they are aware of the same issue, or any similar issue, in their jurisdiction. More specifically, all of the respondents stated that they are not aware of any entities in their jurisdictions that prepare or are trying to prepare the financial statements stated in constant purchasing power units in non-hyperinflationary situations. Some, though, are aware of entities having foreign subsidiaries that operate in hyperinflationary economies.

Agenda criteria assessment

29. In this section, we assess the issues against the agenda criteria of the Interpretations Committee described in paragraphs 5.16–5.17 of the *Due Process Handbook*. The Interpretations Committee should address an issue:

    (a) that has widespread effect and has, or is expected to have, a material effect on those affected;

    (b) where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods;

    (c) that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*;

    (d) that is sufficiently narrow in scope that the Interpretations Committee can address the issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs; and

    (e) for which a solution developed by the Interpretations Committee will be effective for a reasonable period of time. If the issue relates to a current

or planned IASB project, justification of the short-term improvements is necessary.

30. As shown in the results of our outreach activities, we have not identified any jurisdictions in which entities prepare, or are trying to prepare, the financial statements stated in constant purchasing power units in non-hyperinflationary economies. Accordingly, we think that the results of the outreach indicate that neither Issue 1 nor Issue 2 is widespread.

31. Consequently, we think that these issues do not meet the Interpretations Committee's agenda criteria. This is primarily because the results of our outreach indicate that the issues are not significantly widespread in accounting practice.

Staff recommendation

32. We are of the view that an entity has no ability to use the financial capital maintenance concept defined in terms of constant purchasing power units in its IFRS financial statements in the light of the requirements in applicable IFRSs. The only exception is the case in which the entity applies the accounting model in IAS 29 because IAS 29 applies to the entity.

33. In addition, we think that neither issue would meet the agenda criteria of the Interpretations Committee because our outreach activities indicate that these issues are not significantly widespread.

34. Consequently, we recommend that the Interpretations Committee should not add these issues to its agenda.

Questions for the Interpretations Committee

Question 1
Does the Interpretations Committee agree with the staff recommendation that it should not add these issues to its agenda?

Question 2
If the Interpretations Committee agrees with the staff recommendation, does it agree with the proposed wording for the tentative agenda decision in Appendix A?

Appendix A—Proposed wording for the tentative agenda decision

IAS 29 *Financial Reporting in Hyperinflationary Economies*—Applicability of the concept of financial capital maintenance defined in terms of constant purchasing power units

The Interpretations Committee considered the questions:

(a) whether an entity is permitted to use the financial capital maintenance concept defined in terms of constant purchasing power units that is described in the *Conceptual Framework* when the entity's functional currency is not the currency of a hyperinflationary economy as described in IAS 29 *Financial Reporting in Hyperinflationary Economies*; and

(b) if permitted, whether the entity needs to apply IAS 29 to its financial statements prepared under a specific model of that concept of financial capital maintenance when it falls within the scope of IAS 29.

The Interpretations Committee observed that when preparing financial statements under IFRS an entity is required to apply an IFRS that specifically applies to a transaction, other event, or condition in accordance with paragraph 7 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

For example, the requirements for subsequent measurement of intangible assets under the cost model in paragraph 74 of IAS 38 *Intangible Assets* would be inconsistent with restating intangible assets in terms of the measuring unit current at the end of the reporting period, which would be required in a model of the financial capital maintenance concept defined in terms of constant purchasing power units. The Interpretations Committee noted that the amount of cost adjusted for changes in a general price level would not meet the definition of the term 'cost' in paragraph 8 of IAS 38. It also noted that other IFRSs such as IAS 2 *Inventories* and IAS 16 *Property, Plant and Equipment* define or describe the term 'cost' similarly.

Consequently, the Interpretations Committee observed that, because of the requirements in IFRSs, an entity is not permitted to use a model under that capital maintenance concept in its IFRS financial statements, except when the entity is required to apply IAS 29 because it falls within the scope of IAS 29.

The Interpretations Committee noted that the *Conceptual Framework* indicates that an entity should select a capital maintenance concept on the basis of the needs of the users of its financial statements. The Interpretations Committee noted however that the *Conceptual Framework* is not an IFRS and therefore nothing in the *Conceptual Framework* overrides the requirements of any specific IFRS.

The Interpretations Committee noted that the results of the outreach indicate that these issues are not widespread. For this reason the Interpretations Committee [decided] not to add these issues to its agenda.

Appendix B—Extract of submission

IFRIC POTENTIAL AGENDA ITEM REQUEST

The Issue:

The Conceptual Framework (2010), Par. 4.59 states:

> 'Financial capital maintenance can be measured in either nominal monetary units or in units of constant purchasing power.'

Par. 4.59 (a) does not specifically indicate whether financial capital maintenance in units of constant purchasing power is applicable during low inflation, high inflation, hyperinflation or deflation.

IAS 29 Financial Reporting in Hyperinflationary Economies, Par. 8 states:

> 'The financial statements of an entity whose functional currency is the currency of a hyperinflationary economy, whether they are based on a historical cost approach or a current cost approach, shall be stated in terms of the measuring unit current at the end of the reporting period.'

As a result of the fact that it is currently generally accepted by accountants in countries implementing IFRS that IAS 29 is always required during hyperinflation, please indicate whether the following two statements are valid or not:

1. In terms of The Conceptual Framework (2010), Par. 4.59 (a), financial capital maintenance in units of constant purchasing power is applicable during low inflation, high inflation, hyperinflation and deflation.
2. In terms of IAS 29 Financial Reporting in Hyperinflationary Economies, Par. 8, this standard is only required for the restatement of historical cost and current cost financial statements and not in the case of financial capital maintenance in units of constant purchasing power during hyperinflation since all items in the latter financial statements would already be measured either

    (a) in terms of the measuring unit current at the balance sheet date (e.g., the CPI); or

(b) in terms of IFRS-authorized measurement bases current at the end of the reporting period (e.g., fair value, net realizable value, recoverable value, present value, etc.),

excluding nominal Historical Cost (updated Historical Cost to be used under financial capital maintenance in units of constant purchasing power), i.e., excluding the stable measuring unit assumption which is never implemented under financial capital maintenance in units of constant purchasing power.

Current Practice:

It is currently generally accepted by accountants in countries implementing IFRS that IAS 29 is always required during hyperinflation.

Reasons for the IFRIC to address the issue:

(a) The issue is widespread: most accountants believe that IAS 29 is always required during hyperinflation.

(b) The issue involves significantly divergent interpretations since a proposed emerging practice, namely, the Argentinean Federation's 2010 proposal for a future replacement of IAS 29, in the form of a draft IFRS, entitled IFRS 'X' INFLATION, amended in January 2012 to IFRS 'X' CONSTANT ITEM PURCHASING POWER ACCOUNTING (corrected later by the submitter to "IFRS 'X' CAPITAL MAINTENANCE IN UNITS OF CONSTANT PURCHASING POWER"), is based on the core principle of financial capital maintenance in units of constant purchasing power at all levels of inflation and deflation, including during hyperinflation. The IASB voted unanimously in May 2012 to submit the replacement of IAS 29 to research.

(c) Financial reporting would be improved through the elimination of the diversity, namely, indicating now that financial capital maintenance in units of constant purchasing power during hyperinflation is already authorized in IFRS, namely, in The Conceptual Framework (2010), Par. 4.59 (a). In fact, it was authorized in April

1989, the date the original Framework (1989) was authorized.

(d) The issue is sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Conceptual Framework, but not so narrow that it is inefficient to apply the interpretation process.

(e) The issue relates to the current IASB research project regarding the replacement of IAS 29. There is a pressing need for guidance sooner than would be expected from the IASB research project regarding the replacement of IAS 29 especially with regard to hyperinflation in Venezuela and high inflation in, for example, countries like Ethiopia (20%), Tanzania (15.7%), Mongolia (15.6%), Nigeria (11.7%), Angola (10%) and Argentina (10 or 20%).

Submitted by

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Appendix C—The submitter's commentary on a proposal for amendments to IAS 29 submitted to the IASB by the Argentinian standard-setter, the Federación Argentina de Consejos Profesionales de Ciencias Económicas

Comment Letter: IFRS 'X' Capital Maintenance in Units of Constant Purchasing Power

Submitter Organization Date

Nicolaas Smith Constant Item Purchasing Power Accounting 26 January 2012

International Accounting Standards Board

30 Cannon Street

London EC4M 6XH

United Kingdom

Dear Mr Hoogervorst,

I wish to thank the IASB and the Special Commission created by the Federación Argentina de Consejos Profesionales de Ciencias Económicas for giving me access to the Commission´s Research Paper: Inflation.

I would kindly like to make the following comments regarding this excellent research paper.

The Argentinean Federation states that:

The proposal is for International Financial Reporting Standards to be 'in a position to provide an adequate answer to the effects of inflation on financial reporting;'

'An inflation rate of 100% over three years (the limit currently included in IAS 29) equals 26% per year, but much lower rates are sufficient to distort financial statements, if inflation effects are not properly recognized,' and

'The main effects of inflation on financial statements' relate to items such as capital contributed and comprehensive income.

The Federation indicates in the **Basis for Conclusions, Effects of the omission of inflation restatements** that inflation affects revenues, expenses, inventories, property, plant, equipment, intangible assets, investment properties, goodwill, dividends and interest.

It is noted that:

'Inflation is always and everywhere a monetary phenomenon,' per Milton Friedman.

'Purchasing power of non monetary items does not change in spite of variation in national currency value.'

Gucenme, U. and Arsoy, A. P. (2005). *Changes in financial reporting in Turkey, Historical Development of Inflation Accounting 1960 – 2005*. *Special Issue Accounting for the Global and the Local: The Case of Turkey.* Critical Perspectives on Accounting, Volume 20, Issue 5, July 2009, p. 568–590.

Inflation and deflation have no effect on the real value of non-monetary items.

Comprehensive income, revenues, expenses, contributions from and distributions to owners and interest, for example, are constant real value non-monetary items. Inventories, property, plant, equipment, intangible assets, investment properties and goodwill are variable real value non-monetary items. IAS 29 defines them as non-monetary items. The definition of a constant real value non-monetary item is derived in IFRS.

It is not inflation and deflation affecting the real value of constant real value non-monetary items not maintained constant over time. It is the implementation of the stable measuring unit assumption as part of the traditional Historical Cost Accounting model during inflation and deflation.

Inflation erodes the real value of only monetary items not inflation-adjusted in terms of a Daily Consumer Price Index. Deflation creates real value in only monetary items not deflation-adjusted in terms of a Daily Consumer Price Index. It is currently (2012) impossible to inflation-adjust or deflation-adjust bank notes and coins. Their real values are always affected by inflation and deflation.

Inflation in many different countries has no effect on the real value of monetary items inflation-adjusted in terms of a Daily CPI, for example the more than 2.68 trillion US Dollars (2009)[1] of government inflation-indexed bonds currently inflation-adjusted daily in the world economy in terms of a Daily CPI which is a lagged, daily interpolation of the monthly published CPI.

[1] (Standard Life Investments. (2012). *An Investor´s Guide to Inflation–Linked Bonds*. Retrieved 7 January 2012, from Standard Life Investments' Web site.)

According to the *Banco Central de Chile,* 20 to 25 per cent of the broad M3 money supply in Chile is currently inflation-adjusted daily in terms of the *Unidad de Fomento* (Written communication. (2011)) which is a monetized daily indexed unit of account started in 1967 and published daily by the *Banco Central de Chile* since 1990.

The above are all monetary items that exist in a zero cost of inflation (not zero inflation) space. They are all monetary items, but, their real values are not affected by inflation. Inflation-adjusting the entire money supply (excluding bank notes and coins of the fiat functional currency created by means of fractional reserve banking within an economy) under complete co-ordination would result in zero cost of inflation (not zero inflation) in only the complete money supply (as qualified) in an economy.

The requirement in IAS 29, Par. 9 that 'the gain or loss on the net monetary position shall be included in profit or loss and separately disclosed,' deals with the 'effects of inflation' on only monetary items not inflation-adjusted in terms of a Daily CPI only during hyperinflation.

However, the definitions of monetary items in IAS 29, Par. 12 and IAS 21, Par. 8 need to be improved because non-monetary items are all items that are not monetary items. The definition of monetary items thus determines which items are non-monetary items per IFRS. When the definition of monetary items is incorrect then the division of monetary and non-monetary items is incorrect as it currently is in terms of IFRS.

IAS 29 is ineffective[2] regarding the effect of the stable measuring unit assumption (not the 'effects of inflation') on constant real value non-monetary items, e.g. capital contributed and comprehensive income, not maintained constant during hyperinflation.

[2] See my comment letter on the Agenda Consultation 2011.

A monetary item is one of the three basic economic items:

(a) Monetary items

(b) Variable real value non-monetary items

(c) Constant real value non-monetary items

Definition

Monetary items are units of money held and items with an underlying monetary nature which are substitutes for units of money held.

Examples of units of money held are bank notes and coins of the fiat currency created within an economy by means of fractional reserve banking. Examples of items with an underlying monetary nature which are substitutes for money held include the capital amount of: bank loans, bank savings, credit card loans, car loans, home loans, student loans, consumer loans, commercial and government bonds, Treasury Bills, all capital and money market investments, notes payable, notes receivable, etc. when these items are not in the form of money held.

The concept of a constant real value non-monetary item is derived in IFRS

IFRS are principles based standards. The definition of a constant real value non-monetary item is derived from the authorization of financial capital maintenance in units of constant purchasing power as the third capital maintenance concept at all levels of inflation and deflation in IFRS in the original Framework (1989), Par. 104 (a), (now the Conceptual Framework (2010), Par. 4.59 (a)) which states:

'Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.'

When financial capital maintenance is measured in units of constant purchasing power it means, in principle, that capital (all items in shareholders´ equity) is a constant real value non-monetary item and that the real value of capital is equal to the real value of net assets.

Definition

A constant real value non-monetary item is a non-monetary item with a constant real value over time whose value within an entity is not generally determined in a market on a daily basis.

Examples include borrowing costs, comprehensive income, interest paid, interest received, bank charges, royalties, fees, short term employee benefits, pensions, salaries, wages, rentals, all other income statement items, issued share capital, share premium accounts, share discount accounts, retained earnings, retained losses, capital reserves, revaluation surpluses, all accounted profits and losses, all other items in shareholders´ equity, trade debtors, trade creditors, dividends payable, dividends receivable, deferred tax assets, deferred tax liabilities, all taxes payable, all taxes receivable, all other non-monetary payables, all other non-monetary receivables, provisions, etc.

On the other hand: a non–monetary item which is not a constant real value non–monetary item is a variable real value non–monetary item.

Examples include quoted and unquoted shares, property, plant, equipment, inventory, intellectual property, goodwill, foreign exchange, finished goods, raw material, etc.

Definition

A variable real value non-monetary item is a non-monetary item with a variable real value over time.

The Argentinean Federation states:

'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.'

'It is not acceptable either that accounting uses as the common denominator a measurement unit whose value is variable.'

'The use of different currencies in different times or circumstances during a period would be unreasonable. However, the current IFRSs allow preparing the financial statements by using a currency that may have a very different value at the beginning and the end of the period.'

All functional currencies within free and open internal economies, with no governmental interference in monetary policy, generally do not have a constant real value over time for more than a month or two. A functional currency is generally unstable in real value over time within a free and open internal economy.

One of the underlying principles of the globally implemented, generally accepted, traditional Historical Cost Accounting model is the stable measuring unit assumption whereby it is assumed that changes in the purchasing power of money are not sufficiently important to require financial capital maintenance in units of constant purchasing power during inflation and deflation. HCA was originally authorized in IFRS in the Framework (1989), Par. 104 (a) as an optional accounting model. The other option authorized in Par. 104 (a) in 1989 was financial capital maintenance in units of constant purchasing power at all levels of inflation and deflation under which there is no stable

measuring unit assumption. Financial capital maintenance in units of constant purchasing power is fundamentally different from financial capital maintenance in nominal monetary units (HCA).

'In the opinion of the Commission, the application of the proposed standard will significantly improve the financial reporting by requiring that all the components in a set of financial statements be expressed in the same unit of measurement.' Covering letter, p. 8

The Argentinean Federation thus requires financial capital maintenance in units of constant purchasing power in the application of the proposed standard. I agree with the Federation´s choice.

'The financial statements from the application of the mechanism proposed will recognize both gains and losses produced by the effects of inflation on monetary items.' p. 8

The Argentinean Federation thus recognizes that inflation and deflation only affect the real value of monetary items not inflation-adjusted and deflation-adjusted daily, respectively, in terms of a Daily Consumer Price Index and not non-monetary items.

'The financial statements will recognize losses produced by impairment losses that remain concealed when financial statements are not adjusted.' p. 8

The Argentinean Federation thus recognizes that there are two totally different processes of real value erosion involved in an economy during inflation:

(1) One eroding the real value of only monetary items not inflation-adjusted daily in terms of a Daily CPI, namely, the economic process of inflation and

(2) A totally different one eroding only the real value of constant real value non-monetary items not maintained constant daily, namely, the implementation of the Generally Accepted Accounting Practice of applying the stable measuring unit assumption during inflation under HCA as authorized in IFRS in 1989.

Everybody who implements IFRS has to choose a capital concept which will indicate the capital maintenance concept as well as the measurement bases which determine the accounting model to be used. There are three capital and capital maintenance concepts authorized in IFRS:

(a) Three concepts of capital

The concepts of capital in the Conceptual Framework (2010), paragraph 4.57 give rise to the following three fundamentally different concepts of capital during inflation and deflation:

(i) Physical capital. See Par. 4.57 & 4.58.

(ii) Nominal financial capital. See Par. 4.59 (a).

(iii) Constant purchasing power financial capital. See Par. 4.59 (a).

(b) Three concepts of capital maintenance

The concepts of capital in Par. 4.57 give rise to the following three fundamentally different concepts of capital maintenance during inflation and deflation:

(i) **Physical capital maintenance.** Optional during inflation and deflation. The Current Cost Accounting model is prescribed in IFRS when the physical capital maintenance concept is implemented. See Par. 4.61.

(ii) **Financial capital maintenance in nominal monetary units** (HCA). Authorized in IFRS but not prescribed—optional during inflation and deflation. See Par. 4.59 (a).

(iii) **Financial capital maintenance in units of constant purchasing power.** Authorized in IFRS but not prescribed—optional at all levels of inflation and deflation. See Par. 4.59 (a).

It is clear from the Argentinean Federation´s covering letter that they propose to implement the third capital maintenance concept authorized in IFRS, namely, financial capital maintenance in units of constant purchasing power, in the proposed new IFRS.

Certain rules for financial capital maintenance in units of constant purchasing power are defined in IAS 29 which makes it a very important IFRS.

It is clear that the Argentinean Federation proposes a change of the fundamental accounting model: a departure from HCA.

‘Restatement of financial statements’ as required in IAS 29 is not a departure from HCA.

IAS 29 Par. 39 (b) states:

'The following disclosures shall be made:

(b) whether the financial statements are based on a historical cost approach or a current cost approach.'

PricewaterhouseCoopers states:

'Inflation-adjusted financial statements are an extension to, not a departure from, historical cost accounting.'

PricewaterhouseCoopers. (2006). *Financial Reporting in Hyperinflationary Economies, Understanding IAS 29*, p. 3.

It is clearly the intention of the Argentinean Federation to affect a fundamental change in the financial capital maintenance concept implemented, namely, from financial capital maintenance in nominal monetary units (HCA) to financial capital maintenance in units of constant purchasing power: a departure from what is done in terms of IAS 29.

Taking all of the above into account:

When entities implement a fundamental change in their accounting model, namely, financial capital maintenance in units of constant purchasing power when annual inflation is equal to or greater than 10 per cent or cumulative inflation over three years is equal to or greater than 26 per cent, as the proposed new IFRS would require them to do, it would, in my opinion, not be reasonable to require them to change back to a

fundamentally different accounting model, namely, financial capital maintenance in nominal monetary units (HCA) when inflation returns to lower levels.

(1) Primarily when it is taken into account that financial capital maintenance in units of constant purchasing power as proposed by the Argentinean Federation would automatically maintain the constant purchasing power of shareholder´s equity constant for an indefinite period of time in all entities that at least break even in real value at all levels of inflation and deflation – ceteris paribus – whether they own any revaluable fixed assets or not.

When entities follow the Argentinean Federation´s proposal and when they then experience and see and realize in practice for themselves and when the automatic, indefinite-period, real value maintaining effect of financial capital maintenance in units of constant purchasing power in terms of a Daily CPI at all levels of inflation and deflation as qualified above is specifically pointed out to them, then it would not be reasonable to require them to go back to HCA: to require them to go back to implementing the very erosive stable measuring unit assumption again.

(2) It also has to be noted that the Argentinean Federation stated:

‘Most of the Commission members have considered that such decision would involve a drastic change in the accounting practices, particularly, for those countries without an inflationary track-record.’

(3) It would also be very costly to an entity and to a country´s economy as it has always been in the past and as it still is today:

Although nominal financial capital is always equal to nominal net assets measured in nominal monetary units under financial capital maintenance in nominal monetary units (HCA) as authorized in IFRS, it is only true in real value during inflation in the single case where an entity always invests 100 per cent of the original updated real value of all contributions to shareholders´ equity in revaluable fixed assets (revalued or not) with an equivalent updated fair value which is most probably only the case in hotel, hospital and other property-intensive entities.

In the vast majority of cases the stable measuring unit assumption (not inflation - as generally accepted) erodes the real value of that portion of shareholders´ equity (e.g. total retained earnings) never maintained constant under HCA with sufficient revaluable fixed assets (revalued or not) currently amounting to vast amounts of constant item real value eroded in the world´s capital investment base each and every year for as long as HCA is implemented as the global, traditional accounting model. (See the ongoing financial crisis).

(4) Financial capital maintenance in units of constant purchasing power as proposed by the Argentinean Federation would automatically stop this erosion for an indefinite period of time in all entities that at least break even in real value at all levels of inflation and deflation – ceteris paribus – whether they own any revaluable fixed assets or not, and instead would maintain vast amounts per annum for an unlimited period of time in constant item real value in the world´s capital investment base at current levels of world inflation - if it were to be implemented worldwide.

Prof. Rachel Baskerville, Associate Professor, School of Accounting and Commercial Law at the Victoria University in Wellington, New Zealand, changed her publication *100 Questions (and Answers) about IFRS* (question 38) on the Social Science Research Network to confirm that there are three concepts of capital maintenance authorized in

IFRS after I pointed it out to her. Prof. Baskerville discussed the change with her colleague Prof. Kevin Simpkins before changing her article. He is the Chairman of the New Zealand Accounting Standards Review Board. She then added this conclusion to her article:

'There is much to be gained from moving away from reporting on the basis Financial Capital Maintenance in Nominal Monetary Units.' (Baskerville, 2010)

The Deutsche Bundesbank very wisely stated:

'The benefits of price stability, on the other hand, can scarcely be overestimated, especially as these are, in principle**,** unlimited in duration and accrue year after year.'

Deutsche Bundesbank. (1996). *Annual Report*, p. 83.

Financial capital maintenance in units of constant purchasing power as proposed by the Argentinean Federation would mean automatic complete 'price stability' for an indefinite period of time in the constant purchasing power of an entity´s shareholder´s equity as qualified above and consequently in that part of a country´s and the world´s capital investment base if it were to be applied worldwide.

In my opinion entities should be required to carry on with financial capital maintenance in units of constant purchasing power at all future levels of inflation and deflation once they have made the fundamental change from financial capital maintenance in nominal monetary units (HCA) to financial capital maintenance in units of constant purchasing power.

The understanding of the very erosive effect (the cost) of the stable measuring unit assumption (not inflation) on the real value of only constant real value non-monetary

items never maintained constant under HCA during inflation (currently still generally confused with or seen as the same as the cost of inflation in monetary items not inflation-adjusted daily in terms of a Daily CPI which is not calculated and accounted under HCA during low inflation and deflation) as well as the automatic, indefinite, real value maintaining effect on constant real value non-monetary items of financial capital maintenance in units of constant purchasing power in terms of a Daily CPI at all levels of inflation and deflation as qualified above (authorized in IFRS in 1989) are not yet generally accepted, but easy to understand.

Entities implementing the stable measuring unit assumption (HCA) operating in economies with inflation rates below 10 per cent per annum or below 26 per cent cumulative inflation over three years should be very strongly encouraged to change over to financial capital maintenance in units of constant purchasing power as proposed by the Argentinean Federation. They should then not be required to change back to HCA at any future rate of inflation or deflation.

Financial capital maintenance in units of constant purchasing power requires a daily rate

I agree with the Argentinean Federation that the Consumer Price Index should be used as a general price level index.

It is noted that:

(1) When it is intended to maintain the real value of an item, for example, a government inflation-indexed bond, it is immediately realized that a Daily Consumer Price Index is required since these bonds trade on a daily basis. Many countries use Daily CPIs to value these bonds on a daily basis.

(2) During hyperinflation a daily US Dollar (or other relatively stable foreign currency) parallel rate is always spontaneously used by the population and in the consumer markets.

(3) Brazil, for example, used government supplied daily indices from 1964 to 1994 to index non-monetary items on a daily basis in the entire economy during 30 years of very high inflation and hyperinflation of up to 2000 per cent per annum.

(4) Chile has been using a monetized daily indexed unit of account, the *Unidad de Fomento,* since 1977. Its daily value is calculated and published daily by the *Banco Central de Chile* since 1990.

(5) Prof. Robert Shiller stated:

'Another coordination problem is that we must decide, and agree, on a way to smooth the CPI. We should not define prices just in terms of the latest CPI because the CPI is vulnerable to sudden jumps from month to month. This is particularly true when we are talking about indexing financial contracts to the CPI. A unit of account like the UF would smooth out the CPI movements, otherwise there would be important jumps in deposit balances on the dates of new announcements of the CPI. Thus, the smoothing of the CPI in producing the UF has also been a fundamental part of the functioning of the UF as an analogue of money.'

Shiller, R.J. (1998). *Indexed Units of Account: Theory and Assessment of Historical Experience.* Cowles Foundation Discussion Paper, No 1171, p. 13.

A Daily CPI is thus a fundamental requirement when implementing financial capital maintenance in units of constant purchasing power in terms of a daily rate as the basic accounting model in the economy.

Many countries issue government and commercial inflation-indexed bonds. The most liquid markets are US Treasury Inflation Protected Securities (TIPS), the UK Index–linked Gilts and the French OATi/OAT€I market. Japan, Germany, Italy, Canada, Australia, Sweden, Iceland, Portugal, Greece, Finland, Netherlands, Spain, Saudi Arabia, Qatar, Kuwait, UAE, South Korea, New Zealand and Hong Kong also issue inflation–indexed government bonds, as well as a number of Emerging Markets such as Brazil, Turkey, Chile, Mexico, Colombia, Argentina and South Africa.

The British government began issuing inflation–linked Gilts in 1981.

Most of these countries use a Daily CPI to value these bonds on a daily basis. A Daily CPI is a one or two month lagged, daily interpolation of the monthly published CPI.

A country which issues inflation–indexed government bonds and uses a one or two month lagged interpolated Daily CPI to determine the daily prices of these bonds can use the Daily CPI (already in use in many countries for many years) for the implementation of financial capital maintenance in units of constant purchasing power in terms of a daily index at all levels of inflation and deflation as proposed by the Argentinean Federation.

A country with no inflation–indexed sovereign bond market can use a Daily CPI based on the formula used to calculate the *Unidad de Fomento* in Chile.

The Central Bank of Chile translates the *Unidad de Fomento* on their website as An Inflation–Indexed Accounting Unit and CPI–Indexed Unit of Account (UF).

The *UF´*s nominal value in Chilean escudos was originally (1967) updated every quarter which would be the official rate for the following quarter. The nominal index was updated monthly from October 1975, with the currency changeover to pesos, till 1977. Since July 1977 the change in the nominal value was calculated daily by interpolation between the tenth of each month and the ninth of the following month, according to the monthly variation of the *Indice de Precios al Consumidor (IPC),* the Chilean Consumer Price Index. The *Banco Central de Chile* has calculated and published the *UF´*s value daily since 1990. The *UF* is a monetized lagged daily interpolation of the monthly published Chilean CPI. The *IPC* is independently calculated and published monthly by the Chilean National Statistical Institute.

The *UF* daily rate is available on the Chilean Central Bank´s website.

Using the CPI published monthly may result in sudden increases or decreases in values on the date the new monthly CPI is published. A Daily CPI solves this problem: it smooths the CPI. There are no surprises. The *UF* is a very successful monetized daily indexed unit of account used in Chile during the last 45 years (2012) and was copied by Colombia, Ecuador, Mexico, and Uruguay.

A Daily CPI is the daily index used to calculate the daily price of a government inflation–indexed bond in a particular country or is based on the formula used to calculate the *UF* in Chile.

Formula

'The UF is now a lagged daily interpolation of the monthly consumer price index. The formula for computation of the UF on day t is:

$UF_t = UF_{t-1} \times (1+ \pi)^{1/d}$

where π is the inflation rate for the calendar month preceding the calendar month in which t falls if t is between day ten and the last day of the month (and d is the number of days in the calendar month in which t falls), and π is the inflation rate for the second calendar month before the calendar month in which t falls if t is between day one and day nine of the month (and d is the number of days in the calendar month before the calendar month in which t falls).' (Shiller, 1998, p.3)

The above formula applies to the *UF* in Chile where the CPI for the current calendar month used to be available on the tenth of the next calendar month. The general case formula for a *UF* – based Daily CPI is stated as follows:

On day t

$DI_t = DI_{t-1} X (1 + \pi)^{1/d}$

where π is the monthly inflation rate for the second calendar month before the calendar month in which t falls if t is on or between day one and the day of publication of the CPI of the previous calendar month (and d is the number of days in the calendar month before the calendar month in which t falls), and π is the monthly inflation rate for the calendar month preceding the calendar month in which t falls if t is on or between the day the CPI for the previous calendar month is published and the last day of the month (and d is the number of days in the calendar month in which t falls).

A Daily CPI is very similar to, but not exactly the same as a monetized daily indexed unit of account, e.g. the *UF* in Chile. The *UF* is monetized; i.e. it is stated in terms of the Chilean peso. A Daily CPI is not automatically monetized.

A Daily CPI is, like the monthly CPI on which it is based, a non–monetary general price level index value. Monetization depends on generally accepted monetary practices in an economy (see the *UF* in Chile). A Daily CPI can be monetized and used as a monetized daily indexed unit of account with payments being made in the national monetary unit – depending on users in an economy. Monetization is not a necessity.

A Daily CPI is not a unit of account just like the CPI is not a unit of account for accounting purposes. The US Dollar, Euro, Yen, Yuan, etc. are the internal nominally fixed monetary units of account, unstable in real value, used in their respective countries as the national unstable monetary unit of account for accounting purposes during low inflation, high inflation, hyperinflation and deflation. The US, EU, Japanese and Chinese CPIs are not units of account for accounting purposes. They are non–monetary general price level indices. So are their Daily CPIs. Prices are not quoted in CPIs or in Daily CPIs – although they can be.

Conclusion

IFRS are principles based standards. The Argentinean Federation´s proposed new IFRS should thus state the principles involved in financial capital maintenance in units of constant purchasing power in terms of a Daily CPI at all levels of inflation and deflation.

They include:

1 The real value of capital is always equal to the real value of net assets.

2 The capital concept to be implemented: Constant purchasing power capital.

3 The capital maintenance concept to be implemented: Financial capital maintenance in units of constant purchasing power in terms of a Daily CPI at all levels of inflation and deflation.

4 The stable measuring unit assumption is never implemented under capital maintenance in units of constant purchasing power in terms of a Daily CPI.

5 Monetary items are units of money held and items with an underlying monetary nature which are substitutes for units of money held.

6 Non-monetary items are all items that are not monetary items

7 Non-monetary items are sub-divided in:

(a) Variable real value non-monetary items and

(b) Constant real value non-monetary items.

A variable real value non-monetary item is a non-monetary item with a variable real value over time.

A constant real value non-monetary item is a non-monetary item with a constant real value over time whose value within an entity is not generally determined in a market on a daily basis.

8 Daily measurement is required of all items in terms of:

(a) a Daily Consumer Price Index or monetized daily indexed unit of account, e.g. the *Unidad de Fomento* in Chile, during low inflation, high inflation and deflation and

(b) in terms of a relatively stable foreign currency parallel rate (normally the US Dollar daily parallel rate) or a Brazilian-style *Unidade Real de Valor* daily index rate during hyperinflation. Hyperinflation is defined in IAS 29 as cumulative inflation being equal to or approaching 100 per cent over three years, i.e. 26 per cent annual inflation for three years in a row.

Measurement

9 Historic and current period monetary items are required to be inflation-adjusted on a daily basis as detailed above. When they are not inflation-adjusted on a daily basis during the current financial period then the net monetary loss or gain as defined in IAS 29 is required to be calculated and accounted. All monetary items of the fiat currency created within an economy by means of fractional reserve banking except actual bank notes and coins of this currency can be inflation-adjusted on a daily basis within an economy. This would remove the total cost of inflation (not inflation) from the entire money supply except from actual bank notes and coins which generally make up about seven per cent of the money supply in advanced economies.

10 Current period variable real value non-monetary items are required to be measured on a daily basis in terms of IFRS excluding the stable measuring unit assumption and the cost model in the valuation of property, plant, equipment and investment property after recognition. When they are not valued on a daily basis in terms of IFRS as qualified, then they as well as historic variable real value non-monetary items are required to be updated daily in terms of a Daily CPI as indicated above. Current period impairment losses in variable real value non-monetary items are required to be treated in terms of

IFRS. They are constant real value non-monetary items once they are accounted. All accounted losses and profits are constant real value non-monetary items.

11 Historic and current period constant real value non-monetary items are always and everywhere required to be measured in units of constant purchasing power in terms of a Daily CPI as detailed above.

12 The calculation and accounting of the net constant item loss or gain is required when constant real value non-monetary items are not measured daily in terms of a Daily CPI in units of constant purchasing power.

13 Once an entity has started financial capital maintenance in units of constant purchasing power in terms of a Daily CPI, it is required to continue with that model at all future levels of inflation and deflation.

14 Entities in economies with inflation rates below 10 per cent per annum or cumulative inflation over three years below 26 per cent should be very strongly encouraged to implement financial capital maintenance in units of constant purchasing power as proposed by the Argentinean Federation. Countries should be strongly encouraged to do this on a national basis.

15 Inflation and deflation only affect the real value of monetary items not inflation-adjusted and not deflation-adjusted, respectively, on a daily basis in terms of a Daily CPI.

16 The stable measuring unit assumption affects the real value of only constant real value non-monetary items not maintained constant daily by means of measurement in units of constant purchasing power in terms of a Daily CPI at all levels of inflation and deflation.

17 The terms ‘restatement’, ‘restated’, ‘inflation restatements’ and ‘inflation-adjustment of financial statements’ are not be used in the proposed new IFRS.

18 The proposed new IFRS is a departure from Historical Cost Accounting at all levels of inflation and deflation.

I support the Argentinean Federation´s excellent proposal as qualified in this comment letter as well as in the attached appendix in which I suggest some improvements to the Argentinean Federation´s proposal which would, in my opinion, result in effective comprehensive financial capital maintenance in units of constant purchasing power in terms of a Daily CPI at all levels of inflation and deflation which would automatically maintain the constant real value of shareholders´ equity constant for an indefinite period of time in all entities that at least break even in real value at all levels of inflation and deflation – ceteris paribus – whether they own any revaluable fixed assets or not.

An ideal title for the new IFRS would be Capital Maintenance in Units of Constant Purchasing Power.

Please do not hesitate to contact me if you need any further clarifications regarding the concepts stated or any aspect of this comment letter and appendix.

Yours sincerely,

Nicolaas Smith

Constant Item Purchasing Power Accounting

I promote financial capital maintenance in units of constant purchasing power as authorized in the original Framework (1989), Par. 104 (a) in terms of a Daily Consumer Price Index at all levels of inflation and deflation.

CIPPA automatically maintains the constant purchasing power of shareholders´ equity constant for an indefinite period of time in all entities that at least break even in real value at all levels of inflation and deflation – ceteris paribus – whether they own any revaluable fixed assets or not.