IAS29 FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES

A CRITICAL REVIEW – NECESSITY, APPROPRIATENESS & ACCURACY

INTRODUCTION

It seems that at the beginning one must both apologize for having the temerity to question an *issued and accepted International Accounting Standard* and to ask that there be open-mindedness to the various points raised; in the opinion of the writer, any simple dismissal of "challenge" based on the perception that the orthodox cannot and must not be challenged is neither professional nor, more importantly, in the interests of the profession as a whole. The writer does not profess to be either academician or theoretician yet believes that the imprecise natures of hyperinflation and general purchasing power indices requires that these be considered against the general principles which govern the accounting discipline.

> *"The existence of changing prices has presented the accountant with a philosophical problem which shows no sign of resolution in the near future.*
>
> *Accounting originated as a process of recording transaction of a financial nature. The double entry system of bookkeeping to record transactions led naturally to the use of historical cost as a basis of measurement. Further, traditional conservatism led to the realization concept that in terms of which revenue is not recognized until an arm's length transaction has occurred, such as a sale to a third party.*
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> *In times of inflation, the prices of commodities alter, but at varying rates. The overall effect of the movements may be computed by some measure of general inflation, such as a consumer price index; whereas movements of individual items or groups of like items may be measured by a specific index."* (SA GAAP page 219)

That the whole issue of IAS29 in Zimbabwe is contentious (one is reminded of the demise of the old SSAP16 Current Cost Accounting in the early 1980's) and will have both its proponents and critics, the latter group being, primarily, the sector charged with compiling and living with it (i.e. commerce and industry) does mean that a close re-look is warranted. The fact that twice now a representative task force established under the stewardship of The Institute Of Chartered Accountants Of Zimbabwe has referred it back with recommendations for review and, at least temporary, setting aside of The Standard is testament to there being a problem. The fact that the Accounting Practices Board does not seem to have taken cognizance of this situation is very disturbing and, furthermore, that certain individuals consign "user-concerns" to the *waste basket of ignorance* is, at the very least, condescending in the extreme.

The purpose of this review is to consider The Standard as writ in terms of its necessity, appropriateness and accuracy of formulation. It is perhaps, appropriate at this juncture to make clear that the writer has no quarrel with the fact that Zimbabwe is experiencing high-super-hyper inflation (call it what you will) and that the effects of such rampant levels of inflation are relatively more debilitating upon the financial performance and future of a Zimbabwean based company than a company situate in a country where inflation rates are much lower; in this disclosure-regard the writer is **an advocate of disclosing inflation-effect related information** to shareholders and the like – it is merely the format and content of this information which is under debate.

The approach adopted is to firstly consider “what hyperinflation is”, secondly to restate the fundamentals of accounting and financial reporting, thirdly to précis the essentials of The Standard and fourthly to overlay all three “considerations” to “check for congruence”. Unfortunately based on past experience with this issue I can see no shortcut in approach.

INFLATION / HYPER-INFLATION

To begin any review of IAS29 means that one must initially consider what inflation/hyperinflation is and how businesses operate in these conditions else there is no relevance for The Standard.

For a standard to be a standard it must be applicable anywhere in the world (at least where the defined conditions exist) and local peculiarities ignored excepting where they are relevant either by way of illustration or to highlight specific difficulties with the full and true implementation of The Standard. To this end, excepting where unavoidable and identified, discussion will be kept as much to the principles of The Standard as possible.

Whilst there is considerable debate about a true definition of hyperinflation, and most often cited examples refer to several thousands of percent a month rates, the official and accepted definition and characteristics supporting The Standard are as hereunder however, it is pertinent to note that it is widely held that there is no standard definition (or percentage) of hyperinflation and that hyperinflation is “… just out-of-control inflation at an extremely high rate…”.

The Standard’s Definition:

(a) the general population prefers to keep its wealth in nonmonetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;

(b) the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;

(c) 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;

(d) interest rates, wages and prices are linked to a price index; and

(e) the cumulative inflation rate over three years is approaching, or exceeds, 100%

In support of the above the following "brief description" bears consideration:

> *"In the extreme, as prices shoot up sharply and unevenly, normal economic relationships are disrupted. Business owners do not know what to charge for their products. And consumers do not know what to pay. Resource suppliers will want to be paid in kind, rather than with rapidly depreciating money. Creditors will avoid debtors to escape the repayment of debts with cheap money. Money becomes virtually worthless and ceases to do its job as a standard of value and medium of exchange. The economy may literally be thrown into a state of barter. Production and exchange grind towards a halt, and the net result is economic, social, and very possibly political chaos. Hyperinflation has precipitated monetary collapse, depression, and sociopolitical disorder (Pg. 188).*
>
> *…. Such dramatic hyperinflations as those just documented are almost invariably the consequence of **imprudent expansion of the money supply** by government (Pg. 189, emphasis added)".*
>
> *McConnell, Campbell R. Economics. Tenth Edition. New York: McGraw-Hill, 1987.*

The above two descriptions in almost every respect match the writer's own observations and experiences in Zimbabwe and to the extent that these descriptions describe *hyperinflation* then the writer fully agrees that hyperinflation exists when the above conditions exist. That said, there are a number of concerns with the above some of which may, at least in terms of this paper, be Zimbabwe specific but may well be relevant elsewhere and therefore bring into concern the economic basis for The Standard.

To review:

1. generally, the use of a stable foreign currency either as an inflation hedge asset and/or as a price-trading mechanism is indeed a fair characteristic of a hyperinflationary economy
2. expectations of future inflation abound most certainly and
3. there is usually an attempt to index interest rates, wages and prices to some form of price index whether formally or informally

That said if one considers the above in the context of McConnell's description of a disruption to "normal economic relationships" and the "net result" of "economic…chaos" then, firstly, inflationary expectations and hence behavior are susceptible to wide variance of any attempt at reasonable prediction and secondly, there is – as in Zimbabwe – every likelihood that the indexing of rates, wages and prices doesn't occur especially under conditions of price control (even if these conditions are adhered to).

Furthermore, in considering even the somewhat arbitrary 100% (or near 100%) rate of cumulative inflation at what point does, say, a declining rate of, say, 95% cease to be of concern and then what about 80% and so forth until one actually reaches first-world inflation rates? The point about inflation is that it is a rate-of-change which is always relative (never absolute) to itself, its past and its trading partners thus the potential to create a large "grey area" where the impact of inflation may still be severe yet, technically, not a situation of hyperinflation; thus when technically not hyperinflation but yet a serious inflation problem the mandatory influence of IAS29 magically disappears. Inflation/hyperinflation is always a relative/moving target. One of the fundamental problems with incorporating the economic issue of inflation/hyperinflation with "empirical accounting" is this **relative nature** of inflation; relative to other players, relative to other markets (local & foreign) and relative rates of increase/decrease.

Thus we have a situation where the above "descriptions" adequately describe the environment within which a business impacted by hyperinflation exists yet although hyperinflation is a relatively indeterminate and moving circumstance it is nevertheless used as a basis to change the financial accounting and reporting of a company. This situation means that whatever indices or calculations are applied there is every probability that they are not empirically accurate/representative and are out-of-date by the time adjusted accounts are produced; this seems to the writer to be an inappropriate basis to adjust a set of results which have as their fundamentals "identified and quantified transactions".

In hyperinflationary economies it seems that the "rate-of-change" is more significant than the absolute movement. By way of illustration, a company achieving a nominal improvement of 90% period-to-period against a backdrop of 100% inflation has regressed by 10% but so to has a company which achieved a nominal 4,5% improvement against an inflation level of 5,0%. If one accepts that rate-of-change is crucial – and arithmetic will show this by reverting 1000% annual inflation rates to equivalent daily rates – then one must consider the time-usefulness of reported information. Quite often the unitary GPPI/CPI may be months behind thus by the time inflation adjusted accounts are available inflation has moved on so materially that even these numbers are of questionable relevance; in conditions of, say +1000% inflation, is a monthly index appropriate when people are, for example, being paid weekly?

There are a number of other traits exhibited in hyperinflationary environments and which are only, in part, alluded to in the official description of hyperinflationary conditions and yet are fundamental issues when considering the formulation of an accounting standard to "address the problem of hyperinflation" (these include observations made of Zimbabwean conditions):

- the business cycle time (i.e. working capital) comes under extreme pressure and shortens to the extent that cash transactions increase and potential "over-trading" is <u>created externally to the company</u>
- increased money supply is skewed in distribution across the economy thus reducing the general ability of operations to adjust prices either in line with "price indices" or "expectations" which, in turn, reduces the ability to trade-out of inflation or maintain position within that inflation; margins often remain static
- that other abnormal factors (price, wage & exchange controls), are introduced distorting and even disarticulating "normal model interactions" such "supply & demand" and "fiscal & monetary policies"… the consequence of this is that traditional stewardship techniques become, at least in part, invalid
- there is an understandable short-term approach to business and which revolves around "survival" for unless there is survival there is no point in "planning long-term"; for survival read "going concern/capital maintenance"
- there is the realization that under hyperinflationary conditions, savings in local currency terms lose their value… one cannot out-save hyperinflation… and this increases the need to "hold and use" assets <u>for trading</u> and <u>not investment</u> purposes; even if those assets are traditionally not "normal trading assets" they become "trading hedge assets"
- that during periods leading up to, and following achievement of, hyperinflation in many instances performance returns significantly lag inflation thus rendering the "normal" remedy of turning to the market for capital injection unlikely; the result of this, in turn, tends to be an increase in borrowing levels with a concurrent containment of long term (fixed asset) investment whether such is desirable or not – this has implications for The Standard's "net monetary adjustment" balancing item
- that the exchange rate, <u>unless artificially held</u> as is often the case, will adjust to reflect the relative inflation differentials between trading partners; this is a very important issue for it adjusts (ceteris paribus) fairly quickly to prevailing economic conditions; inter-market comparisons are thereby accounted for anyway
- that bankers tend to look towards the <u>ability to service debt</u> in monetary units not relative pricing terms i.e. in flow of units of "dollars" and towards <u>realizable values</u> of assets in terms of security; the more traditional debt/equity ratio diminishes in importance and replacement values of limited relevance
- that traditional price indices, usually set up in economically stable periods associated with fairly predictable trading and purchasing patterns, may/do become questionable in terms of being representative of reality as behavior changes
- that in many respects whilst dysfunctional, skewed and hyperinflationary conditions prevail, economies tend to become

“closed” to outside investment (disinvestments being more prevalent) as foreigners place their funds elsewhere; internally, to the extent possible local investors hedge off-shore or resort to other non-capital investments such as treasury bills where there is a short-term high return (when interest rates are high) and minimal perceived risk – long term investment all but disappears

These points do not seem to have been factored in to the economic backdrop against which IAS29 has been developed. The Standard uses characteristics that are certainly descriptive of hyperinflation and underscore the ravages of hyperinflation but which seems, to the writer, to be a flawed basis upon which to develop a Standard because of both the indeterminate nature (the nature of inflation itself) and incompleteness of circumstance (not fully accommodating other hyperinflationary characteristics). Any standard developed to tackle a particular issue or circumstance must be in congruence with that situation and not either deficient or selective. As an aside, if standards are to move into the realms of economics then surely the whole spectrum of severe economic conditions such as “stagflation” and “deflation” must also be embodied somewhere.

ACCOUNTING

As “accounting” is the basis for financial reporting it is pertinent to remind one’s self about this as the foundation for financial reporting and, more importantly, ensure that the underpinning principles and bases are relevant and compatible with that standard.

It is noted that generally the IASC has held that where a conflict arises then the requirements of an IAS prevail over “the framework” however this should not be used as a means by which fundamental issues become sidetracked.

That there is much erudite defined bases and frameworks for the preparation and presentation of financial statements is not disputed and there is no intent here to reinvent these issues let alone prepare a treatise but there is a need to précis the background and in this regard the writer has drawn almost exclusively from South African GAAP Statement *AC000 – Framework For The Preparation And Presentation Of Financial Statements*. It is recognized that AC000 is a South African Standard but it does not materially differ from the principles set out in IAS1… it merely happens to be more convenient reference material.

<u>Purpose Of Financial Statements</u>

… to:

a) decide when to buy, hold or sell an equity investment;
b) assess the stewardship or accountability of management;
c) assess the ability of the enterprise to pay and provide other benefits to its employees;

d) assess the security for amounts lent to the enterprise;
e) determine taxation policies
f) determine distributable profits and dividends;
g) prepare and use national income statistics; or
h) regulate the activities of enterprises

(Preface to AC000 – extracted from IASC)

Objective Of Financial Statements

a) The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. (AC000 para12)

b) Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information. (AC000 para13)

c) Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management. (AC000 para 14)

Underlying Assumptions

a) accrual basis
b) going concern
c) understandability
d) relevance
e) materiality
f) reliability
g) faithful representation
h) substance over form
i) neutrality
j) prudence
k) completeness
l) comparability
m) timeliness
n) balance between benefit and cost
o) true and fair view/fair presentation

(adapted from AC000 paras 22 – 46)

The Elements Of Financial Statements

a) Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics… The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the income statement are income and expenses…. (extracted from AC000 para 47)

b) Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements. (AC000 para 69 emphasis added)

c) The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves. (AC000 para 81)

d) Recognition of the "elements of financial statements" is dictated by:
   a. "it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
   b. the item has a cost or value that can be measured with reliability." (adapted from AC000 paras 82 & 83)

e) Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement. (AC000 para 99)

f) A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:
   a. Historical cost….
   b. Current cost….
   c. Realisable *(settlement)* value….
   d. Present value….

   (extracted from AC000 para 100)

g) Imputation of the "Concept Of Capital Maintenance" and which is "… concerned with how an enterprise defines the capital it seeks to maintain. It provides the linkage between concepts of capital and concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capital and its return of capital…" (extracted from AC000 para 105)

h) "… At the present time, it is not the intention of the Board of IASC to prescribe a particular model [of capital maintenance] other than in exceptional circumstances, such as for those enterprises reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments." (AC000 para 110) The writer queries the correctness and appropriateness for a standard such as this – dealing with economics – to prescribe a particular model of capital maintenance in order to "solve" the problem of hyperinflation.

Thus the background and preconditions to be met by a standard.

IAS 29 (PRECIS OF SALIENT POINTS)

A fundamental element of The Standard is the presumption that a General Purchasing Power Index (GPP-I) is appropriate for use; conceptually credible but one must question whether empirically and appropriately accurate and suitable. Whilst the writer is no statistician, a GPP-I such as the local CPI is biased towards domestic consumption, with average prices being applied to a specific, yet subjective in many respects, basket of products and which have certain weightings applied; whether or not any "smoothing" for such issues as seasonality are used the writer cannot comment upon. Whilst undoubtedly accurate from a statistical calculation perspective, I suggest such indices are by their very generalist and biased nature imprecise when applied to accounting science.

The Standard:

a) *"In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading."* (IAS29 para2) At first glance a reasonable statement and in general terms understandable. That said, the statements of the absolutes, without supporting explanation, of *"…not useful…"* and *"… misleading…"* are assumptions. These assumptions when juxtaposed with the statement of *"… Standard does not establish an absolute rate at which hyperinflation is deemed to arise. It is a matter of judgement when…"* makes for a poor argument for mandatory implementation. Furthermore, the description of *"meaningless"* is very bold, stark and unqualified when viewed against the backdrop that despite hyperinflation, the historical cost methodology does "faithfully record the transactions" and is such used as the very basis for IAS29 based financial statements in the first place. At the end of the day, historical cost accounts still balance back to the net monetary unit value at bank… is this totally *meaningless*?

b) *"Prices change over time as the result of various specific or general political, economic and social forces. Specific forces such as changes in supply and demand and technological changes may cause individual prices to increase or decrease significantly and independently of each other. In addition, general forces may result in changes in the general level of prices and therefore in the general purchasing power of money."* (IAS29 para 5) A fair statement but the concept of general purchasing power is <u>added as a rider</u> *("… in addition…")* <u>but has been used as the basis</u> for IAS29. This is not logical and detracts from each individual company's own particular industry sector and structure… an attempt to “paint the whole town beige”. To promote more realistic reporting, surely more attention should be paid to *“…Specific forces…”*?

c) *“…Presentation of the information required by this Standard as a supplement to unrestated financial statements is not permitted…”* (IAS29 para 7). This makes IAS29 indexed accounts “the principal and only accounts”.

d) *“The restatement of financial statements in accordance with this Standard requires the application of certain procedures as well as judgment. The consistent application of these procedures and judgments from period to period is more important than the precise accuracy of the resulting amounts included in the restated financial statements.”* (IAS29 para 10) This statement seems to be in direct conflict with IAS29 para 2 where concern with “traditional” reporting is regarded as *“not useful”* and *“misleading”*; it begs the query as to how much more, or less, useful and misleading is a consistently applied but imprecise arithmetic multiplier exercise?

e) Balance sheet amounts are indexed with the exception of monetary items that are held in monetary unit terms and any net gain or loss is taken to the income statement. This is a departure from traditional practice where unrealized gains/losses (and GPP monetary gains/losses are unrealized in monetary unit terms) are not taken to income but to capital.

f) The restatement of prior periods may not only be confusing to the layman year-on-year but adds complexity to the production of trends and graphical analysis techniques frequently used and derived from “old annual reports”, The Standard seems to make no provision for presentation of restated multiple-year statistics.

g) Does/could a credit to income arising from a monetary adjustment encourage imprudent levels of gearing? If interest rates rise in hyperinflationary conditions (conventional wisdom dictates so) and profits *improved* by *“better management of debt”* (not all interest bearing debt is necessarily monetary in nature) then where is prudence when cash flows become inadequate to sustain debt levels?

h) The income statement requires that the transactions be restated according to the period specific index at date of transaction. This seems at odds with the concept that at date of transaction, the monetary unit value of the transaction has as its basis the specific price index applicable at that time.

i) It has been stated, and is implicit in The Standard in para 29 (restatement specifications for balance sheets prepared under current cost approach) and para 39(b) (requiring disclosure as to whether the financial statements are based on historical cost or current cost), that the application of IAS29 does not change the basis of preparation of financial statements. To the extent that a change from historical cost to current cost reflects a change in accounting policy/preparation basis and that current cost requires a form of indexing (even if partial) then the foregoing statement is inconsistent with the latter fact.

j) A paradox arises where monetary assets and liabilities such as cash and overdrafts are, understandably, not indexed yet their direct product, interest (an item not directly affected by any general purchasing power index even where not artificially held/adjusted), is indexed in the income statement; interest itself translates, in turn, to a monetary asset or liability on the balance sheet. Conventional economic wisdom holds that interest rates be *held as real* therefore at any point in time they are implicitly adjusted for inflation at the time of transaction and shouldn't thus be double-indexed.

k) A fundamental flaw in the standard is that there is no compulsion to disclose or otherwise explain the "net monetary adjustment". Whilst local company reports, which may currently only comment on historical figures, can be forgiven in that there is local tolerance for allowing both sets of accounts to be published this in no way diminishes the significance of this *fundamental item arising on the adoption of IAS29*. It is interesting to note that whilst, apparently, technically provable a good number of accounting professionals have advised clients *"not to worry too much as it is the 'balancing item'"*.

  a. By way of illustration:
     A very good example of this problem is evident in the recently published (28th March 2002) abridged interim results from ZIMRE. The net monetary adjustment turns an attributable profit of some $894M in historical terms into an attributable loss of $770M in IAS29 terms; surely material? Even if the historical figures are ignored, as the inflation loss arises from a net monetary loss adjustment of $2 253M surely the most significant and material reporting item of all? That there is no comment on such a material item is disturbing but the absence of any supplementary information by way of note makes the reported results both *misleading* and not-*useful*. It is interesting to note that despite an inflation loss, the Board has still declared a final dividend of 20 cents per share.

SUMMARY & CONCLUSIONS

Whilst the malaise (hyperinflation) affecting financial reporting is understood and accepted and that there needs to be some form of treatment, the issue is really whether or not IAS29 is the remedy… a partial remedy is no real remedy and cannot, therefore, be enforced as "principal/primary" financial statements. One observation about IAS29 is that it is a standard outside the norm in that it <u>purports to address an economic situation</u> whereas virtually all other IAS's concern themselves with <u>treatment and disclosure of recorded transactions</u>, events and balances extracted from historical cost accounts. Another observation is that while high, not hyper, inflation conditions may prevail, and the effects there under very debilitating, there is no obligation for a company to either adopt current cost accounting or even to regularly revalue its assets (IAS 16) yet the moment hyperinflation is adjudged to exist then revaluations are mandatory - this seems a significant contradiction.

The principal preoccupations of IAS29 as regards hyperinflation seem to be:

a) the principle of capital maintenance
b) the principle of going-concern
c) the rate of loss of General Purchasing Power and the usefulness of general indexing in trying to reflect the loss/gain in economic purchasing power for any particular set of corporate results
d) the usefulness of "traditional" reporting under conditions of high rates of loss of GPP or rather the implication that "traditional" reporting is of <u>no use</u> despite being the basis for an arithmetical exercise
e) the misleading nature of "traditional" reporting under conditions of high rates of loss of GPP
f) the principle that GPP-Indexed accounts are the principal accounts
g) the measurement of company & management performance

The question remains as to whether the above are met by the standard and then whether the standard either meets, or conflicts with, the other "fundamentals of financial reporting" as outlined above. The issues below call into serious question the fundamental premise of The Standard that IAS29 compliant financial statements are to be the principal accounts; this premise is further undermined by the necessity for taxation purposes to maintain conventional historical cost accounts which, in turn, tends to make the act of "management conversion to IAS29" more protracted, at the very least.

<u>Capital Maintenance</u>
There are two aspects here. Firstly, The Standard does not call for management to disclose and explain its approach to, and constraints upon, capital maintenance but prefers to impose a vague general concept as a universal and general remedy. Secondly, in periods of extreme hyperinflation it is unlikely that assets can be re-valued (and adequately accurately impair-adjusted) at fast/adequate enough rates as will ensure capital adequacy. I submit that The Standard does not adequately meet the requirement of Capital Maintenance.

<u>Going-concern</u>
The criticisms as regards Capital Maintenance are applicable here excepting that, in addition, it presupposes that under hyperinflationary conditions the correct business decision is to remain as a going-concern. I submit, therefore, that The Standard does not adequately meet the requirement of Going-concern.

<u>General Purchasing Power Indexing</u>
The following points are relevant:

a) a GPP-Index such as the CPI is not necessarily a true and fair representative of prevailing GPP even if it is the only index in existence
b) a GPP-Index is still historical and in most instances management will be working on inflation-expectations

c) by the time indexed results are to hand, under extreme/exponential rates of hyperinflation, the information is relatively too late and therefore outdated
d) general indices are not necessarily relevant to the industry type and this is especially true where such industry is of long duration such as mining and forestry; a food-based CPI for a 20 year timber cycle skews the reported results whereas under "normal conditions" the differences between supermarkets and forestry operations are embodied in the structure and nature of the results and balance sheet… stakeholders assess based on the industry, their preferences and risk profiles. Within a hyperinflationary economy but not reporting under IAS29 inter-firm comparisons are still possible but without skewing the relationship between them as each is affected, implicitly, by its own specific inflation indices.
e) GPP-Indexes such as the CPI are, in the writer's local experience, significantly different both in quantum and timing from those general indices as apply to both construction costs and plant purchase costs. Thus the use of a CPI assumes that the original purchase price if indexed for general consumption is either sufficiently indicative of replacement costs (depreciation & capital maintenance) or of resale value … resale values worldwide of second-hand plant rarely if ever relate closely to CPI's their being either significantly discounted in first-world markets or "premium rated" in third-world markets; to index and then try and "impair" seems an inappropriate method when there exists professionally qualified valuation experts in the first place.

I submit that The Standard, by applying a GPP-Index, does not adequately meet the requirement being generally useful and thus does not adequately and accurately reflect the effects of hyperinflation.

Traditional Reporting – Usefulness & "Misleading" Qualities

The Standard does **attempt** to address the effects of rampant inflation which undermine the financial soundness of business but the following should be considered:

a) even with education and the onus of users to become semi-financially literate the adjustments for net monetary gains/losses (which are economic concepts and not quantified measurements of transactions) are not easily interpreted; if not meaningfully interpreted then they are not useful
b) as "net monetary adjustments" are economic and not tangible items it begs the question as to whether management can actually use this information (even if it adequately comprehends it) or not; if not then not useful
c) to be useful, reporting needs to be timely and under hyperinflation – assuming indices are immediately available – the normal reporting interval of 1-month can result in markedly outdated information; that The Standard does not address the frequency of reporting interval makes its usefulness questionable
d) in considering "misleading" one needs to consider the following:

a. <u>“relevance”</u>: that the need to address the effects of hyperinflation partially meets the “relevance” criterion; that The Standard does not seem to consider the other significant traits exhibited by a hyperinflationary environment detracts from that relevance
b. <u>“materiality”</u>: that the issue of the effects of hyperinflation are material the “materiality” criterion is met in general terms but by using a GPP-Index can also be misleading on an industry specific basis
c. <u>“reliability”</u>: given the imprecise nature and likely magnitude of indexing factors together with The Statement’s own admission that *“a precise definition of hyperinflation doesn’t exist”* and that *“consistent application … is more important than precise accuracy…”* calls into question the reliability of the indexed financial statements (especially when no reliable degree of error can be quantified) thus the “reliability” criterion is not met
d. <u>“faithful representation”</u> : the issues surrounding “reliability” and adequacy of a uni-GPP-Index by extension means that the criterion of “faithful representation” cannot be assured and therefore not met
e. <u>“neutrality”</u>: to the extent that a uni-GPP-Index is not relevant to a particular company/industry sector by default implies bias and thus the criterion of “neutrality” is not met
f. <u>“comparability”</u> : to the extent that a uni-GPP-Index is not relevant then true inter-company comparability is not possible against the backdrop of hyperinflation as it destroys the normal and unique company differentials thus the criterion of “comparability” is not met; to the extent that exchange rates adjust for inflation differentials and that other non-hyperinflationary economies are not applying IAS29 also means comparability is not met
g. <u>“benefit & cost”</u> : apart from the initial high cost of implementation, against the backdrop of the above points there is no real and measured benefit thus the cost cannot justify the benefit
h. <u>“true & fair”</u> : in the light of the above inadequacies The Standard cannot, by itself, purport to present “true and fair” accounts

If truly useful, then <u>all</u> companies, worldwide, should be adopting and incorporating either The Standard (where applicable) or the essence of The Standard in daily operating reports… what proportion of large non-public companies do this whilst here, in Zimbabwe, there seems to be a pre-occupation with the listed counters.

<u>Principal Accounts</u>
The issue of principal accounts must, on the basis of the above, be a questionable foundation for The Standard and is therefore totally inappropriate

Management Performance

This is a difficult issue but to the extent that firstly, there probably exist abnormal constraints thus negating normal remedies and that secondly, management is in all likelihood working on inflation expectations The Standard by itself is inadequate to judge management performance. The Standard does not call for explanation or supplementary detail to place decision-results into context and, as regards inflation rates, it reduces performance measurement to "adjudging management's ability to guess the future".

It also seems a little incongruous to index "dividends" in the income statement yet the shareholder only receives a dividend (monetary asset?) in net monetary units i.e. dollars and cents.

Of some passing interest is the general "accounting convention/policy statement" employed widely throughout the world in that "… financial statements are prepared under the historical cost convention… exception of certain plant at valuation… and no other procedures have been adopted to reflect the impact of specific price changes or changes in the general level of prices…". This is actually a disclaimer of all inflation until, magically, hyperinflation appears – this does not seem to be a consistent approach.

Finally, it occurs to the writer that the "creation" of either a "net monetary asset" or "net monetary liability" is not too far removed from the principles espoused concerning the identification, definition and treatment of "Intangible Assets" (with immediate period amortization a prerequisite) excepting that this "asset/liability" does not appear to meet the criteria laid down in either IAS32 or IAS38. If, indeed, we do have an intangible asset through application of IAS29 then we also have incompatibility with these two standards as well. The *"IAS29 intangible"* is, surely and logically by its very nature and not by the IAS29 definition, a monetary affair thus the omnibus paragraph 5 of IAS38 cannot be used and yet, an "IAS29 monetary asset" is not in harmony with the IAS32 definitions of *"financial instrument"* and *"financial asset"*.

RECOMMENDATION

Whilst there is need to provide shareholders/stakeholders information as regards the effects of high/hyperinflation IAS29 as a standard and as writ is unnecessary, inappropriate and inaccurate. The "bottom line" is that IAS29 as set out does "not do the job" of adequately explaining the effects of inflation and the concept of GPP-Indexed as **Mandatory Principal Accounts** must be discarded. It is interesting to note that, thus far in Zimbabwe, IAS29 does not seem to have "appropriately influenced" dividend policy where certain "*negative* IAS29 results" have still shown high levels of dividends being declared yet other companies, with good historical cost results, either holding dividend cover or even not declaring dividends *"due to prevailing economic conditions"*.

As regards what to do, I believe a modified version of IAS15 coupled with the various recommendations made by The Task Force can easily be adopted and implemented and, if deemed appropriate, even made mandatory. This would include a format of abridged and appropriately indexed financial statements (no notes) as supplementary information together with added material as to the general economic environment (this could be an ICAZ issued statement for consistency/comparability) plus any other specifics as relate to the individual company's circumstances. Additionally, there should be some commentary as regards management's strategy to deal with the situation; this might also include volumetric information such as day's inventory/debtors to at least partially interpret the inflationary effects of financial quantum. An alternative, using either a realistic or free-market exchange rate, is to simply translate into a stable hard currency; use of a hard currency is becoming increasingly accepted internationally and, significantly, matches both *(a)* and *(b)* of The Standard's own definition of hyperinflation.

B.P. South
March 2002

<u>IAS29 – OPTIONS</u>

<u>Notes Relating To IAS29 Options & Alternatives</u>

In considering alternatives, it is relevant that the important issues affecting disclosure rationale be determined and agreed. To this end, I suggest that the following items are those important issues and relate to any real form of indexing and not merely IAS29 methodology:

1. The relative movement in operating performance between trading periods
2. The relative return on trading versus some form of market bench-mark return
3. The relative reduction in purchasing power of the unit of currency when measured against constant volumes and not the relative benefits of increased borrowing levels as IAS29 disclosure might suggest
4. The attempt to more correctly present the balance sheet investment in fixed assets which pertains when true hyperinflation exists, and revaluations not carried out, but which do not, per se, exist when stagflation conditions prevail
5. The attempt to ensure that adequate replacement-depreciation charges are made for the "infinite long term" thereby implying a "perpetual going concern"
6. The attempt to provide a "real" rather than "nominal" return on a "current asset cost" and not on an "historical investment or sunk cost" basis

If one accepts that the above are correct then, in reverse order, items 4 – 6 become invalid in the present Zimbabwean context due to the severe macro-economic distortions and items 1 –3 would, in my opinion, provide a strong argument for providing a simple and abridged approach to the whole inflation disclosure issue.

Equally, one must not lose sight of the fact that from industry to industry the ability to cope with the demands of ultra-inflation differ markedly even where management has made immense strides in improving efficiencies, reducing waste and taking advantage of alternatives and opportunities. It is, particularly, in this area that non-indexed numbers are probably of more use and attention to physical unit/volume changes becomes more relevant.

One area that has not as yet been considered is the concept of re-indexing the prior period figures to try and arrive at an original base. In keeping with the arguments on indexing fixed assets I think this approach is flawed and in keeping with the premise of trying to show year-on-year improvements/deteriorations I do not think such is necessary. Thus only index the current year back to the prior comparative; additionally there doesn't seem to be much worth in re-indexing only the prior year IF sufficiently detailed re-indexed comparatives for 3 or 5 or 7 or 10 or whatever years as would provide meaningful trends are not computed.

Whilst Radar has, this year, produced a complete set of USD comparatives – based on the premise of comparing results in relatively stable currency terms – it is imperfect for, apart from all distortions associated with any form of indexing (some's worse than others here), the most obvious present drawback of the absence of a free-market exchange rate.

Personally I'd prefer to see a much scaled back approach – too many imponderables, averages, estimates, *incalculables* and the like to warrant IAS29 type approach – where there is, say and by way of note:

1. A general economic statement as to the prevailing conditions in the economy over a particular period – this could be prepared by authoritative economic authorities under a mandate from ICAZ and updated quarterly; one issue which might well need consideration is whether this "statement" should be in the notes to the accounts or is more appropriate as a separate inclusion, say under a financial commentary, in the report as a whole.

2. An abridged trading account indexed to the most appropriate to that particular industry but indexed year-on-year only i.e. prior figures not re-indexed in line with the above reasoning; it might also be necessary to expand the index note where such index is not a from a "pure source" such as the CPI's is from the Dept. Of Census & Statistics and therefore in the public domain

3. A review of working capital management as relates, say, to those hyperinflation combat techniques and which would include stock-turn and debtor/creditor day ratios

4. More emphasis on the business' ability to generate cash and here "free cash flow" is probably more appropriate (again a standard ICAZ approved definition might be warranted); this goes hand in hand with ability to service debt whereas under high inflation and indexing of numbers traditional gearing ratios become fraught with danger; free cash is essentially the cash generating ability of the company produced from operations and which is "available" for shareholders and lenders

5. A statement as to the company's position on asset valuations (remembering that even prior to IAS29 this whole issue was contentious) but perhaps such could include a note as to the values provided for insurance purposes – a latent benefit here might be more assurance to the shareholder that the assets are "adequately" protected for insured perils

I cannot adequately stress the importance of item #1 – the economic commentary. If one accepts that IAS29 is part economics/part accounting and that the intent behind the standard is as much to evidence the effect of economic conditions on the operations of a company as it is for purposes of general disclosure then it is immutable that a proper economic background be painted; such background will also reduce the inferred effects of adopting a uni-index irrespective of industrial sector.

One item of recent vintage as regards the use of the CPI must be the effects of price control… to the extent that these are "effective" then there will be an artificially depressed index which will, for those businesses not subject to control, incorrectly improve the reported results… a situation not as likely to occur where a more specific (and unregulated) index is available/used. Attached and purely by way of illustration are several different indexed figures demonstrating the differing results obtained using different indices and different weighting-periods. What is, perhaps, interesting is that whilst the weighted annual results are not too far different, each six-month set of indexed figures **are significantly different.** The results using “my index” rather than the CPI for each 6-month period reflect a better performance in the June half-year than the December half-year. The point? Well apart from accepting that some form of periodic indexing (as opposed to annual indexing only) is preferable – here maybe six monthly is actually quite adequate to match public reporting – equally the use of an industry-appropriate index is also preferable to the use of a uni-index.

So now to a purely hypothetical and illustrative indication of the above suggestion for alternative disclosure – <u>all figures must be taken as purely illustrative</u>:

NOTE “X” : INFLATION

X.1 <u>Prevailing Conditions</u>: During the period under review, the local economy experienced hyperinflationary conditions as measured by the cumulative and compounded three year CPI where such was, to June 2001, an annual 64% and a three year multiplier of 4,06 times (June 2001 index of 765.7 over June 1998 index of 188.4 based on 100%=1995). Allied to this, is the fact that the real GDP Growth Rate dropped from 2.9% in 1998 to 1.7% in 1999 and a projected –4.2% in 2000. Furthermore, the all sector volume of manufacturing production (1980=100) dropped from 126.3 in 1997 to 108.9 in 1999 with further, anticipated, declines to ??? in 2000 and to ??? in 2001. M3 money supply has continued to grow at a rate of 73,9% in the year to June 2001 and interest rates have been reduced whereby 90-day Bankers Acceptances have declined from 68% in June 2000 to between 10.5% and 31.5% at June 2001. Exchange rates, after a 41% devaluation in August 2000 have been held constant at USD1:ZW$55 by central authorities.

X.2 <u>Abridged Trading Results</u>: based on a six month weighted industry relevant index for the company extracted from the Building Materials Price Index; the weighted index for the year ended June 2001 is 138,7. Comparatives have not been indexed.

	2001 $000	**2000 $000**	**Change %**
Turnover	1 977 156	1 356 729	+ 46
Gross Profit	710 668	459 446	+ 55
Operating Income	258 624	99 978	+ 159

X.3 <u>Working Capital</u>: these figures have not been indexed.

	2001 $000	**2000 $000**	**Change %**
Inventories	360 064	272 145	+ 32
Trade receivables	364 885	267 345	+ 36
Trade payables	300 253	191 120	+ 57
Inventory days	75	111	- 36
Receivables days	49	72	- 23
Payables days	63	78	- 15

X4. Free Cash Flow: these figures have not been indexed.

	2001 $000	2000 $000
Profit/(loss) after tax	149 086	(44 365)
Add: non-cash flow items	59 351	37 804
Add: after tax interest payment	175 385	111 498
Less: cash invested in working capital	(11 809)	(10 354)
Less: investment in fixed assets	(155 258)	(35 738)
FREE CASH FLOW FOR THE PERIOD	216 755	58 845

X5. Asset Valuations: as stated in previous annual reports your Board believes that prevailing conditions preclude any meaningful determination of either replacement or fair-market or impaired values of assets and have thus not adjusted values in the balance sheet since the last valuation conducted in 199X. That said, your company's assets are insured for all-risks perils, with the exception of forest plantations where insurance cover is not available, for a sum in excess of $7Bn