UNICE

THE VOICE OF BUSINESS IN EUROPE

Sir David Tweedie
Chairman
IASB
30 Cannon Street
London EC4M 6XH

11 September 2003

Dear Sir David,

RE: HYPERINFLATION REPORTING

UNICE would like to express its concerns about what we see as the approach being taken by the IASB in respect of accounting for hyperinflationary territories. We have discussed these matters with other preparers' organisations such as ERT which share our worries. The present letter and accompanying background notes have been jointly developed.

For some time many multinationals have used hard currency accounting and reporting for subsidiaries operating in such territories. While systems similar to IAS 29 have also been used for some operations, to manage businesses and report appropriately, both internally and externally, for the varied and volatile nature of such environments around the world, multinationals have adopted more than one method depending on the circumstances in the relevant territory.

In many cases hard currency accounting has been the best way of obtaining meaningful, comprehensible and reasonably reliable financial data for both local and group management and for inclusion in published consolidated financial statements in those situations where the local currency is not a reliable unit of measurement. The hard currency approach was found by both local and group management to provide better financial information than that derived from indexation which is also generally difficult for management to understand and use for managing, planning and control. In the absence of a meaningful unit of measurement local businesses think in hard currency terms.

In determining the approach to be used going forward, any standard needs to place emphasis on:

- reflecting the economic substance of the specific underlying events and circumstances.
- reflecting a currency's use to a significant extent, either directly or in the way the business and the economy think.
- management's responsibility for judging which currency to use to most faithfully represent the economic effects of the underlying transactions when the indicators are mixed.

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We are not suggesting that hard currency accounting should be the rule anymore than that indexation is the only answer. However, UNICE strongly believes that either can be appropriate in particular circumstances and this inevitably involves a somewhat subjective evaluation by management and auditors. The IASB should recognise this rather than imposing costly and unnecessary changes on companies, as well as driving a wedge between internal and external reporting.

The current work being done by the IASB presents an excellent opportunity for reconsidering the most appropriate approaches to reporting for hyperinflationary territories. It is essential that this review not only considers reporting of companies within the country but also how such companies are included in the consolidations of multinational operations. It is also essential that the review of the latter issue is not delayed if, at the same time, a very dogmatic and rigid approach to current requirements is implemented.

For European companies faced with the 2005 deadline to adopt IFRS, and companies elsewhere facing equally short deadlines, the consequences will be severe in terms of cost and a disconnect between internal and external reporting.

Given the constraints of what can be done, it therefore seems more appropriate to separate out the issue of consolidation and treat this as an issue for short-term convergence. As regards the issue of local reporting, if this is to be a longer-term project, then, in the short term, greater flexibility should be retained until the implications have been more thoroughly debated. (In any case, any solution for multinational consolidations would need to properly reflect the restraints imposed by IAS 27 in respect of transferability of funds to the parent in relevant situations.)

UNICE is of the opinion that IFRS should allow a hard currency approach at least for the financial reporting of subsidiaries in hyperinflationary economies to parents in non-hyperinflationary countries and we have attached a somewhat more detailed note setting out our position.

We would be grateful if the IASB could consider the serious consequences for management thinking and decision-making, as well as costs, which will result from what we understand to be their current approach, and give urgent consideration to this matter.

We remain at your disposal should you wish to discuss these matters in closer detail.

We look very much forward to receiving your reply.

Yours sincerely,

(*original signed by*)
Jérôme P. Chauvin
Director, Company Affairs Department

Encl. 1

INFLATION ACCOUNTING

CURRENT POSITION

Our understanding of the current position under international accounting standards is set out in this section.

IAS29 was developed on the basis of systems used within certain countries to address high rates of inflation. As such systems were for local corporate law, taxation etc. they would inevitably be based on local price indices (however unreliable or "fixed") rather than on the exchange rate against a hard currency.

IAS21 requires certain financial statements to be restated in accordance with IAS29 before they are translated. The requirements of IAS29 do not apply to an entity which operates in a hyper inflationary economy but which reports in a relatively stable foreign currency.

IAS29 requires the use of a general price index that reflects changes in general purchasing power in the economy. Nevertheless IAS29 also recognises that, where no suitable general price index is available, it may be necessary to use an estimate based, for example, on the movements in the exchange rate between the reporting currency and a relatively stable foreign currency.

SIC19 requires that the measurement currency for financial statements of an entity should reflect the economic substance of the underlying events and circumstances relevant to the entity. However SIC19 raises some doubt over the use of a stable currency as the measurement currency which is reinforced in the improvements exposure draft. This draft focuses on the use of the "functional" currency for measurement and emphasises that an entity cannot avoid the requirements of IAS29 by, for example, adopting a stable currency as its functional (measurement) currency.

Our current impression is that the audit profession would regard very few situations (if any) as meeting the IFRS tests for a stable currency to qualify as a functional currency. They would tend to look at turnover/receivables being denominated in local currency and even where a number of hard currency costs exists these would not be sufficient for a hard currency to be dominant enough to qualify as a functional currency. This dogmatic approach may be in part affected by the current climate in the audit profession following Enron etc.

There is also an associated concern that this type of approach will lead to an equally rigid view of what qualifies as hyper inflation. Unless there is a reasonable and practical approach, individual countries will fall in and out of qualifying as hyper inflation on too frequent a basis with implications for the quality of reporting and the costs incurred by companies.

These issues are also compounded by the first time application standard which will impact the many companies changing to IFRS, as for a number of companies in Europe in 2005. In this context this proposes that financial statements are restated for IFRS for all periods prior to the date of transition of IFRS.

We also note that the IASB has agreed to remove hyper inflationary accounting from the joint short-term convergence project. Instead, a broader project on hyper inflationary accounting would be undertaken with help from standard setters in Argentina, with perhaps also Mexico. However, there are two related but somewhat separate issues and we are not clear how they will be dealt with

a) What is appropriate/acceptable for reporting locally in hyper inflationary economies?

b) What is appropriate/acceptable for consolidating results from companies based in hyper inflationary countries into the Group results of multinationals?

The references we have seen to the IASB's project might be taken as dealing with (a) but not necessarily (b), although the latter is obviously of primary importance to us.

ISSUE

The above raises important and potentially costly issues for a number of multinationals in various countries. For many years it has been an accepted part of internal and external reporting that subsidiaries in hyper inflationary countries may be best addressed by a hard currency reporting system rather than an indexed system.

Before setting out the major reasons for this, the overall point should be noted that we are not claiming a hard currency system is the perfect or only answer to this problem. However it is misguided to assume there is one right and precise answer in the varied, volatile and sometimes chaotic environments that characterise high inflation economies around the world. The use of a hard currency can be a useful and practical tool in many circumstances, especially where inflation indices are unreliable at best.

Our views are based on the following:

a) Hard currency accounting is a common approach to deal with the issues raised in consolidating the operations of countries with high inflation rates into the accounts of multinational groups. It has proven to be a practical and accepted methodology which gives useful and understandable management information.

b) In theory, the use of hard currency results can be seen as a proxy for indexed results and either can be appropriate to address the problems of reporting. In a perfect world they would give similar results, while in the real world either may be more appropriate depending on the circumstances.

c) Hard currency accounting (similar to SFAS52) tries to overcome the lack of a reliable unit of financial measurement by translating individual transactions into more reliable values as they occur and continues to use those values for subsequent reporting.

d) In contrast the indexation approach uses both:

- indices which can often be subject to one or more of the following:

  - political or governmental manipulation, including adjustments some time after they are initially issued.
  - unreliability because of the process used to collect them and/or geographical diversity within a country and/or the existence of a variety of indices.
  - the impact of an unquantifiable black market and/or subsidised transactions.
  - not transaction specific nor reflecting actual inputs/outputs.
  - not always available on a timely basis.

- exchange rates which are also subject to problems of manipulation.

So effectively we inflate local currency results by indices which can be unreliable and then convert at a questionable point in time exchange rate, which may bear little relationship to the conditions pertaining at the time of the transaction which the reporting process is trying to reflect. This can produce information about the performance of an enterprise that is not useful and does not reflect the economic substance of the underlying events and circumstances. By the end of the process the original transactions can be subject to an accumulation of potential distortions which are quite significant.

e) Hard currency accounting can provide more reliable information in what can sometimes be chaotic environments while it can also be somewhat easier and less costly to deal with in systems terms. Although it may not be sufficient to meet the current interpretation for the use of hard currency, companies will tend to use hard currency accounting for a combination of some or all of the following reasons;

- a number of costs are denominated in hard currency
- debt incurred in hard currency
- they think in terms of hard currency in looking at prices/margins, especially in certain industries
- hard currency gives a better view of replacement costs, which can be key for management in these environments.
- hard currency results are a better management guide to cash generation and the ability to meet liabilities, both those to a parent based in a hard currency environment and those to external parties such as banks and suppliers.
- this is especially so in terms of forecasting in hard currency as opposed to highly volatile and subjective indices.
- numbers generated by an indexed system require more additional review as to reasonableness e.g. impairment.
- based on a reasonably consistent and reliable unit of measurement, hard currency data is much more readily comparable and understandable for group managements.

f) Where there is an unstable economy, high inflation, sudden devaluations or countless economic rescue plans, regardless of how sales prices might be denominated, people will look to a store of value and a reliable unit of measurement i.e. they will think in hard currency terms. In such economies management are not trying to "exactly" adjust for inflation, even if this were practical, but rather to measure the performance of the business on an understandable and useful basis which is aimed to be realistic in cash generation to ensure the continuity and development of the business.

g) Moreover, while for obvious reasons, it will not be acceptable to report in say US$ for local external financial statements, this will be the logic of how management, employees, suppliers etc think and how the parent company not only think but also manages its local operations. One might also question the audit firms who query the use of, for example, the US$ under IFRS but then base their audit fees on US$!

h) The obverse of this that local and parent company management and other stakeholders have problems in thinking and operating in constantly restated local currency units, which can run to many digits. On the other hand, it is much easier to use a hard currency especially as they think in these terms. In practice, regardless of external reporting, there will be a number of cases where hard currency is still used internally to manage the business. Thus we will have a costly and misleading disconnect between internal and external reporting.

i) This is not to say that hard currency accounting will always give a neat and perfect answer because such a result is not possible in many of these environments. No single system will provide the right answer at all times for all countries, and a hard currency system can be distorted by exchange rate manipulation, multiple exchange rates etc. However, we are just trying to illustrate the need for flexibility if the results are to provide the most appropriate reflection of what is happening in the business. Hard currency accounting can give better information at a reasonable cost in a number of cases which is why it has long been regarded as a reasonable approach.

j) In a number of operations hard currency accounting is an integral part of the information systems. Changing to an indexed system or having a duplicate indexed system for external reporting will be a costly exercise. What is the benefit which offsets this real cost to companies?

k) Following on from the prior point, the proposed requirements of the first time application standard will impose further costs on companies changing to IFRS with highly questionable benefits, which seems totally at odds with the objective of the exposure draft. This applies to the general impact from requiring restatement to an indexed system under IFRS. Also, for example, it is possible that a company will be required to restate all its historic hard currency accounting to an indexation basis from a possibly more appropriate hard currency system, even where the country is currently moving out of hyper inflationary environment.

l) A rigid approach to the definition of hyper inflationary territories will also involve too frequent changes in the status of operations. The consequent changes of treatment will involve a disconnect between the underlying transaction systems and financial reporting which companies obviously wish to avoid (as should users). The perception that companies can just change without cost and internal/external reporting complications is simplistic.

m) Even if, as is often the case, specific transaction criteria are local currency based, it may be the case that the substance of economic activity is hard currency based. In other cases it may not be so. This emphasises the need for flexibility in applying accounting to the varied and volatile environments if we are to:

- reflect economic substance
- keep internal and external reporting in line, with external reporting meeting the needs to management and users.
- ensure that external reporting does not results in additional costs which outweigh any real benefits.

n) The concept mentioned in paragraph 10 of IAS29 should be key to any standard on this topic. The consistent application of procedures and judgements from period to period is more important than "precise accuracy" of the resulting amounts included in restated financial statements. Unfortunately, the current trend appears to be that this concept will not be generally applied in this context.