

# INFLATION ACCOUNTING AT INTERNATIONAL LEVEL

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**Abstract:** *The inflation's influence on monetary and non-monetary elements, on the capital and on the account of profit and damage, leads to the adoption of norms, both at a national and international level, which would attenuate the effects of inflation. The economic, political and social particularities determine the implementation of some procedures for adapting of inflation accounting.*

**Key words:** *Inflation, hyperinflation, re-evaluation of non-monetary elements, inflation assessment, inflation accounting.*

## 1. Introduction

The directives no. IV and no. VII of the **European Economic Community** were elaborated for an accounting harmonization of the member countries. The article 33 of the IV Directive specifies that evaluation in yearly accounts is done at the value of replacement of stocks and lock-ups and according to a method which would **take inflation into account** for the other patrimonial elements including financial lock-ups. The difference between historical costs and the new values represents a '**difference from re-evaluation**' which will affect the registered capital and not the results of the enterprise.

The **accounting manipulation** can be done even more easily **in case of high inflation** or hyperinflation. Many companies obtained liquidity through accounting manipulation, through over-evaluation of the financial position and financial performance of the companies they administered.

The financial situations in many cases change from what they should be into what their makers desire, in order to obtain advantages from the existing principles/rules and/or ignoring some of them.

The accounting truth must be built in agreement with a set of specific principles, rules, conventions and practices. However, the accounting truth appears at the conjunction of a compromise between the producers of accounting information, financial auditors and information users. There are many possibilities of accounting manipulation which influence the financial positions and the financial performance of the company, like: the implementation of basic and alternative treatments, the preferential implementation of evaluation in accounting, the rise of the difference between the accounting registered value and acquisition price through an under evaluation of the purchased assets and a charge of the differences regarding the provisions, making 'lease-back operations', through which the sell of an

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asset is done, followed by the buyer's rent of this asset.

The indicators used for measuring the financial position and financial performance of an enterprise, when dealing with an inflationist or hyper-inflationist economy, just like in the case of Romania, must be re-evaluated, from nominal values to real, comparable values.

Even though Romania had a hyper-inflationist economy for more than 10 years, and the inflation at the moment is over the average of the European countries, our country did not have an applicable inflation accounting. If this had been done, the financial indicators would have also been re-evaluated.

## **2. Accounting regulation concerning the inflation at an international level**

In 1973, the International Accounting Standards Committee was formed (IASC) on the basis of an agreement made between the accounting professional organizations from Australia, Canada, France, Germany, Japan, Mexico, Netherlands, the United Kingdom and the United States. IASC has the following targets:

- a) To elaborate a set of accounting global standards, having a high quality, intelligible and applicable, which can claim qualitative, transparent and comparable information in financial situations and other financial reports, in a way which would help the participants at the capital market and other users to substantiate their economic decisions;
- b) To promote and accept a strict implementation of these standards;
- c) To find solutions for the convergence of national standards and of the International Financial Reporting Standards (IFRS).
- d) From 1983, all professional organizations of accountants which had been members of the International

Federation of Accountants became members of the IASC.

This action was necessary for an adequate presentation of the financial situation, following the inflation caused by the petroleum crisis from the 1970s.

In 1983, the IAS 21 norm, 'Accounting for the Effects of Changes in Prices' underlined the lack of consensus at an international level regarding the creation of an accounting system for the inflation.

In 1988, the IAS 29 norm, 'Financial reporting in Hyperinflationary Economies', represented a model of reevaluation of the inflation: the presentation of the information in the general purchasing power, combining the replacement cost with a conversion method, the maintenance of the social capital by affecting the profit, the evaluation and accounting of the effects of inflation on patrimonial elements.

**Inflation accounting** appeared in Europe after the petroleum crisis from the beginning of the '70s, when inflation affected most of the countries of the Old Continent. Under these circumstances, the European countries adopted some measures to reduce inflation and to preserve the enterprises' patrimony.

**In 1975, in Great Britain**, the Inflation Accounting Committee (IAC), elaborated the Sandilands Report, which would consider the problem of accounting at current costs for the first time, leading to the replacement of a project which was based on the method of conversion (indexing with the general index of prices). The Institute of Chartered Accountants (ICA), published in 1976, the document no. 18 (ED 18) called „Current cost accounting”, which proposed a complete system in current costs.

As it was not accepted by all the members of the ICA, ED 18 was withdrawn in 1977 and replaced with an 'Interim recommendation concerning the

inflation accounting'. Through this document, the companies were asked to attach financial reports made in historical costs, a separate report for the results of the operation expenses, which had three re-evaluations:

- A. The supplementation of the amortization obtained as a difference between the actual value (current) and the original value;
- B. The actual cost of the sold merchandize, calculated as a difference between their actual value at the moment of their selling and their historical value;
- C. Financial re-evaluations, if the companies had net monetary liabilities.

Some years later, in 1979, ICA published recommendation no. 24 (ED 24), called 'Current cost accounting', which requested from companies with a turnover of over 5 million pounds to present the balance and the result account in current costs. In 1980, ED 24 led to the publication of a 'Statutory Statement of Accounting Principle' (SSAP 16). SSAP 16 also asked banks to make the inflation re-evaluation.

As a consequence of the decrease of the inflation rate, in 1984, it was only applied to joint-stock companies and the information regarding the current costs was asked only informatively, as appendices to the balance.

**In France**, in 1978, companies were asked to highlight in their financial situations the replacing costs of permanent capitals. The adjustments from the re-evaluations were going to be added to the social capital. These demands were limited only to permanent capitals and did not take into account the effects of inflation on the costs of the sold goods and on debts. Moreover, the demands concerning the inflation were limited to the current year.

**In 1975, the Accountant's Institute from Germany** issued a report which requested that the financial situations'

appendices included a presentation regarding the influences of the boost of prices and the adjustment of permanent capitals in current costs, with the help of some evidence given by the Government. Moreover, the circulating capitals were also adjusted, depending on the relative growth of inflation.

**In the US**, The American Accounting Association recommended in 1966 that all financial situations should be presented in two columns: the historical costs of the patrimonial elements in one, and the actual costs of these elements in the other. In 1969, the Financial Accounting Standards Boards recommended the use of the general index of prices for synthesizing accounting documents. However, none of the companies or enterprises re-evaluated the patrimonial elements using the general index of prices.

The American Institute of Certified Public Accountants (AICPA) published in 1973 a report of financial information which had 12 objectives that the financial reports had to accomplish. The use of a combined evaluation base was recommended, because if the same methods were used for evaluating both the asset and liability elements, the obtained information would not represent accurately the patrimony.

Statement of Financial Accounting Standard 33 (SFAS 33), requested from the enterprises to present annually a set of information following two models: one based on historical costs, and the other one based on the historical cost indexed with the general index of prices. This standard became mandatory by the end of 1979.

SFAS 33 addressed companies which fulfilled the following conditions:

- a) The entering value of the permanent capitals and stocks exceeded 125 million dollars;
- b) The total value of the assets exceeded 1 billion dollars.

After the inflation rate dropped by 2-3% per year (in 1985-1986), all norms regarding the inflation accounting became optional.

**Brazil** is the country which has the most developed system of inflation accounting. The permanent capitals and investments in progress have been adjusted obligatorily at the end of each financial exercise with the general price index given by the Government. The annual accounts from the financial situations were re-evaluated and the result of the exercise became the taxing base from a fiscal point of view. In 1976, through the Law of Commercial Companies, all commercial companies were requested to present financial reports in accordance with the recommendations of inflation accounting.

The implementation of inflation accounting was done in Brazil using two methods:

**The first method** determined that the adjustments were to be made using an **index authorized by the government** and the adjustment regarding the lock-ups was to be made starting from their accounting

value, and was to be attributed to the profit; in the case of liabilities, the shareholders' equity was to be modified. Concretely, a profit reflected either a monetary net gain which came from the adjustments, if the goods were financed from borrowed sources, or a loss of capital, if the shareholders' equity was higher than the necessary trading capital. This method was applied until 1996, when it was abandoned due to the drop in the inflation rate.

**The second method** was based on the current money and was used by the quoted enterprises. The financial situations were adjusted at the current level of prices with the help of an inflation index established by the Brazilian government. The lock-ups, stocks, the shareholders' equity and monetary posts were the ones which had to be adjusted to inflation.

In the following table, you can see a hypothetical example of how the inflation accounting is done in Brazil. The simplified balance of an enterprise is shown in Table 1:

Balance sheet

Table 1

ASSETS	Sum	Liabilities	Sum
Liquid Assets	48.000	Bills of exchange payable	15.000
Lock-ups	180.000	Shareholders' equity	213.000
<b>Total assets</b>	<b>228.000</b>	<b>Total liabilities</b>	<b>228.000</b>

Some further information should be added to Table 1:

- Inflation rate in the financial exercise N = 80%;
- Increase in the general level of prices = 50%;

- Monetary incomes = 300.000;

- Monetary expenses = 210.000.

The lock-ups and shareholders' equities adjustment to inflation is shown in Table 2

Re-evaluation of lock-ups and shareholders' equities

Table 2

No	Adjusted elements	Hist. values	Inflation rate	Adjusted values
1.	Lock-ups	180.000	80%	144.000
2.	Shareholders' equities	213.000	80%	170.400
3.	Value of monetary adjustment	-	-	26.400

Table 3 shows the data from the with the adjustments based on the profit-and-loss account from 31.12.N, monetary correction:

*Profit-and-loss account from 31.12.N*

Table 3

Name of the indicators	Sum
Monetary incomes	300.000
Monetary expenses	(210.000)
Current profit	90.000
Monetary adjustment	(26.400)
Net profit	63.600

The balance from 31.12.N is presented in Table 4:

*Re-evaluated balance from 31.12.N*

Table 4

ASSETS	SUM	LIABILITIES	SUM
Liquid assets (48.000 + 300.000 – 210.000)	138.000	Bills of exchange payable	15.000
Lock-ups (180.000 + 144.000)	324.000	Shareholders' equities	213.000
		Capital provision	170.400
		Net profit	63.600
<b>Total assets</b>	<b>462.000</b>	<b>Total liabilities</b>	<b>462.000</b>

The loss in the purchasing power is presented in Table 5:

*Loss of purchasing power*

Table 5

No.	Explanation	Historical cost	Correction factor	Corrected values from 31.12.N
<b>0</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4 = 2 x 3</b>
1.	Net monetary elements at 01.01.N (48.000 – 15.000)	33.000	180/100	59.400
2.	Discounted incomes	300.000	180/150	360.000
3.	Discounted expenses	(210.000)	180/150	(252.000)
4.	Monetary elements from 31.12. N	123.000	-	167.400
5.	<b>Loss in the purchasing power (167.400 – 123.000)</b>	-	-	<b>44.400</b>

The profit-and-loss account adjusted on the basis of the general index of prices is presented in Table 6:

*Profit-and-loss account re-evaluated from 31.12.N*

Table 6

<b>Indicators</b>	<b>Historical cost</b>	<b>Adjustment factor</b>	<b>Sum</b>
Monetary incomes	300.000	180/150	360.000
Monetary expenses	(210.000)	180/150	(252.000)
Current profit	90.000	180/150	108.000
Loss in purchasing power	-	-	(44.400)
Net profit		-	63.600

**Conclusions:**

After the adjustment, the current profit decreased from 90.000 in historical cost values, to 63.000, values expressed in current costs, the monetary adjustment of 26.400 being equal with the loss in the purchasing power, as a consequence of holding monetary elements (33.000 x 80%).

As a consequence of inflation, the company paid additionally a profit tax of 26.400 lei.

**L'Institut Canadien des Comptables Agréés (ICCA)** (the Canadian Institute of Chartered Accountants) recommends that one should not use the indexing method with the prices' indexes, this method being unknown to accountants and considering that, from the point of view of internal control, the accounting in historical costs satisfies all demands. In 1975, ICCA published a checking note called 'Verifier of the financial documents indexed with the general price level presented as a supplement to the annual report' and the recommendation 'Accounting variation in the purchasing power of money', through which only the joint stocks had to make the re-evaluations starting the 1<sup>st</sup> of January 1977.

A year later, ICCA published the first working document 'Accounting in present values', which wanted to collect data in order to get a better understanding of different accounting variants in present values and to have enough information for debates. As a consequence of the companies' reaction, the indexing based on

the general price level was replaced with the actual cost method.

In 1979, the method proposed by the UK through the Sandilands Report was adopted, through the document 'Accounting based on actual costs'. This document addressed only those companies which had a value of the stocks and lock-ups of over 50 million Canadian dollars, or a total of assets of over 350 million Canadian dollars. In 1982, this method was replaced again by the American one, but in 1989, due to the decrease in the inflation rate, the implementation of these recommendations came to an end.

**Australia** has known many phases in the development of inflation accounting. In the first phase it had a temporary accounting standard, which recommended that accounting in current costs should be applied to lock-ups and stocks in primary financial situations. In the second phase, the attention was drawn to the handling of the losses and gains in the purchasing power. In 1979, a report was published called 'The recognition of gains and losses in the holding of monetary assets in the context of accounting in current costs. In the third phase, the Australian accounting institutions issued a new report for current costs which extended the commission for current costs to other elements of the financial situations, including those expressed in currencies.

In the beginning of 1983, all companies with assets of over 20 million Australian dollars and governmental enterprises with assets of over 100 million Australian

dollars introduced additional profit-and-loss accounts and balances reflecting the adjustments at the current costs for the depreciation, the sell and gain costs and losses from the monetary assets. The companies could choose the financial situations expressed in current costs as primary financial situations. In this case, further financial situations were requested, based on the historical cost.

In March 1982, **New Zealand** elaborated through the Accountants' Society, The Current Costa Accounting Standards No.1, CCAS 1, 'information reflecting the prices' variation', with a similar content of that of the Standard SSAP 16, issued by Great Britain.

In **Argentina**, the first recommendations were made in 1972 by the organization of liberal profession, ATIPA, and they demanded the publication of some additional reports starting from 1973, the Financial Situation of the General Purchasing Power.

Only few companies followed the recommendations given by ATIPA, presenting the annual accounts in invariable money, starting from the indexes of the trade price.

The efforts to introduce an accounting system in the general purchasing power in Chile were not supported at first by the government,; however, in 1975 it was officially announced that Chile was the first country which applies an accounting based on the general purchasing power.

In 1976, through the Royal Decree concerning the Enterprises' Financial Situation, **Belgium** permitted the use of the **current costs** in the recording of stocks, permanent capitals, costs of sold goods and amortization in primary financial situations, in the form of footnotes.

In **Netherlands**, despite the absence of any request, an accounting principle generally accepted is the introduction of the measurements of the current value of

replacements in the annual accounts. Influenced by the replacement value theory developed in the 1920s by the professor Th. Limperg from Amsterdam University, the big companies of this country, like Phillips for example, evaluate some stocks and depreciable assets at the **replacement current values**, registering depreciations based on the replacement value and expenses associated with the sells costs in the result account and the provisions gotten from the re-evaluation in the section related to the social capital of the balance.

### 3. Final conclusions

Inflation showed its horns because of the present economical crisis. Wall Street and 'The City' in London, the core of the international finance, were going to collapse and were saved only by the states' intervention. Who could have imagined that the Royal Bank of Scotland could have been a new Bancorex, and the British government now owns 80% of the shares? It can be risky to foresee the future and very often unpredictable.

An inflation accounting is justifiable if a country has a hyperinflation (over 100%) for a long time – at least 3 years. But no one wants this, because the implementation of an inflation accounting means additional efforts made by the companies, and it is not in the countries' interest to obtain less money, as a consequence of the re-evaluation of the financial situations, done in case of inflation.

If the concept of maintaining the financial and the physical capital was respected, requirements which can be found in the International Financial Reporting Standards, the enterprises would pay a lower profit tax, because, in fact, they also pay an **inflation tax**. But for the country, all the additional money it can get is important, even if in time this leads to the decapitalization of the companies.

Romania continues to have a high

inflation, 8,1% if we look at the interval December 2010-December 2009, meaning an average inflation of 6,2%, much higher than the one accepted by the European Union of 1,6%. However, the predictions concerning the average inflation are optimistic: 5,3% in 2011, 3,5% in 2012, 3,2% in 2013, 2,8% in 2014. Let us hope that these predictions will come true and that, in the future, we will not have to think about an inflation accounting.

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