UITF Abstract 9
Accounting for operations in hyper-inflationary economies

The issue

1 SSAP 20 'Foreign currency translation' states that "where a foreign enterprise operates in a country in which a very high rate of inflation exists it may not be possible to present fairly in historical cost accounts the financial position of a foreign enterprise simply by a translation process. In such circumstances the local currency financial statements should be adjusted where possible to reflect current price levels before the translation process is undertaken". However there is some uncertainty as to when and how this guidance should be applied in practice.

2 The overriding requirement to give a true and fair view of the profit or loss and state of affairs can be considered to require appropriate adjustments to be made where significant distortions arise from very high rates of inflation ("hyper-inflation"). Because it is a common condition, users of financial statements have developed tolerance for some inflation and in varying degrees allow for it in their analyses. The distortions caused by hyper-inflation may in practice be diluted by the relative rates of inflation in the reporting country and in other countries where the reporting entity operates, when taken together with the relative size of the operations in hyper-inflationary economies in the context of the reporting group.

3 The question of what constitutes hyper-inflation is necessarily judgmental. International Accounting Standard No. 29 "Financial Reporting in Hyperinflationary Economies" describes a number of characteristics of the economic environment of a country which indicate hyper-inflation (see the Appendix to this Abstract). Failure to adjust for hyper-inflation before application of the SSAP 20 closing rate/net investment method of translation produces a significant debit to group reserves, whilst at the same time inflated profits are included in the group profit and loss account (whether from high interest income on deposits in a rapidly depreciating local currency or from trading operations at what could be considered unrealistically high profitability).

4 Methods adopted to eliminate distortions caused by hyper-inflation need to take account of the following factors:

(a) the lack of reliable and timely inflation indices in a number of hyper-inflationary economies can pose a major practical problem to adjusting local currency financial statements;

(b) it is necessary to have regard to the particular local circumstances as these can vary significantly between countries in terms of how real profitability should be measured.

Application to smaller entities

4A Reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt from this Abstract.

UITF Consensus

5 The Task Force reached a consensus that adjustments are required where the distortions caused by hyper-inflation are such as to affect the true and fair view given by the group financial statements. In any event adjustments are required where the cumulative inflation rate over three years is approaching, or exceeds, 100% and the operations in the hyper-inflationary economies are material.

6 The Task Force considered that the following two methods of eliminating the distortions were consistent with SSAP20 and therefore acceptable:

(a) adjusting the local currency financial statements to reflect current price levels before the translation process is undertaken, as suggested in paragraph 26 of SSAP20. This includes taking any gain or loss on the net monetary position through the profit and loss account.

(b) using a relatively stable currency (which would not necessarily be sterling) as the functional currency (i.e. the currency of measurement) for the relevant foreign operations. For example in certain businesses operating in Latin American territories the US dollar acts effectively as the functional currency for business operations. The functional currency would in effect be the "local currency" as defined in paragraph 39 of SSAP 20. In such circumstances, if the transactions are not recorded initially in that stable currency, they must first be remeasured into that currency by applying the temporal method described in SSAP 20 (but based on the dollar or other stable currency rather than sterling). The effect is that the movement between the original currency of record and the stable currency is used as a proxy for an inflation index.

7 If neither of the above methods is considered appropriate for material operations, then the reasons should be stated and alternative methods to eliminate the distortions should be adopted.

8 Where group operations in areas of hyper-inflation are material in the context of group results or net assets, the accounting policy adopted to eliminate the distortions of such inflation should be disclosed.

Date from which effective

9 The accounting treatment required by this consensus should be adopted in financial statements relating to accounting periods ending on or after 23 August 1993, but earlier adoption is encouraged. In order to ensure consistency of treatment, corresponding amounts for preceding years should be restated where applicable.

References

Accounting standards

SSAP 20 'Foreign Currency Translation' paragraphs 26, 39 and 55
International Accounting Standard 29 'Financial Reporting in Hyperinflationary Economies'

EDITORIAL NOTE: NOT PART OF THE ABSTRACT

Date of publication and subsequent amendments

UITF Abstract 9 was issued on 9 June 1993.

Paragraph 4A was inserted by the Financial Reporting Standard for Smaller Entities (FRSSE), issued November 1997, and amended by the FRSSE (effective March 1999) in December 1998.

END OF EDITORIAL NOTE

Appendix

Extract from IAS #29 'Financial Reporting in Hyperinflationary Economies'

"3 This Statement does not establish an absolute rate at which hyperinflation is deemed to arise. It is a matter of judgement when restatement of financial statements in accordance with this Statement becomes necessary. Hyperinflation is indicated by characteristics of the economic environment of a country which include, but are not limited to, the following:

(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%."