The IFRS Foundation 14 January 2014

Dear Sirs/Mesdames,

Thank you for the opportunity to comment on the IASB's Discussion Paper: A Review of the Conceptual Framework for Financial Reporting.

Please find my detailed answers in the Appendix.

Yours sincerely,

Nicolaas Smith
Capital Maintenance in Units of Constant Purchasing Power

I promote **Capital Maintenance in Units of Constant Purchasing Power** in terms of a Daily CPI or other daily index at all levels of inflation and deflation including hyperinflation as originally authorized in IFRS in the Framework (1989), Par 104 (a) which states: *'Financial capital maintenance can be measured in either nominal monetary units **or units of constant purchasing power.'***

CMUCPP automatically maintains the constant purchasing power of capital constant for an indefinite period of time in all entities that at least break even in real value during inflation and deflation, including hyperinflation - all else being equal.

APPENDIX

Answers to the IASB's Discussion Paper: A Review of the Conceptual Framework.

Section 6 Measurement

Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35.

The IASB’s preliminary views are that:

a. the objective of measurement is to contribute to the faithful representation of relevant information about:

I. the resources of the entity, claims against the entity and changes in resources and claims; and

II. how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources.

b. a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;

c. when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;

d. the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:

i. for a particular asset should depend on how that asset contributes to future cash flows; and

ii. for a particular liability should depend on how the entity will settle or fulfil that liability.

e. the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and

f. the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

RESPONSE

No, I do not agree with these preliminary views because they are not complete. They only deal with measurement in terms of financial capital maintenance defined in terms of nominal monetary units. IFRSs are also written from the perspective of an entity using the concept of financial capital maintenance that is defined in terms of units of constant purchasing power.

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

Par. 15. Having made a choice of using the financial capital maintenance concept in constant purchasing power units, the entity would develop accounting policies by referring to an IFRS that addresses a transaction, other event or condition analysed in accordance with paragraph 10 of IAS 8. ***The entity would need to adapt each IFRS for the use under***

***that capital maintenance concept**."*

Agenda ref 12 STAFF PAPER 10–11 September 2013 IFRS Interpretations Committee Meeting
Project IAS 29 Financial Reporting in Hyperinflationary Economies
Paper topic Applicability of the concept of financial capital maintenance defined in constant purchasing power units

IFRS, excluding (1) *IAS 29 Financial Reporting in Hyperinflationary Economies* and (2) *IFRIC 7 Applying the Restatement Approach under IAS 29*, are written from the perspective of an entity using the concept of financial capital maintenance that is defined in terms of nominal monetary units (Historical Cost Accounting). This is however a fallacy.

IAS 29 and IFRIC 7 are written from the perspective of an entity using the concept of financial capital maintenance that is defined in terms of units of constant purchasing power in terms of the measuring unit current at the end of the reporting period, i.e., in terms of the monthly published Consumer Price Index. IAS 29 does not result in capital maintenance in units of constant purchasing power during hyperinflation because of the use of the monthly published CPI. IAS 29 had no positive effect in Zimbabwe: the Zimbabwean economy imploded on 20 November 2008 despite the fact that IAS 29 had been implemented during the final 8 years of hyperinflation in that country. Equity can only be maintained constant in real value with capital maintenance in units of constant purchasing power in terms of an index that follows all (at least DAILY) changes in the general price level. This did not and does not happen under IAS 29.

The majority of entities are based on the concept of equity (capital) being equal to net assets under the double-entry accounting model. I am not referring specifically to the HCA model, but simply to the double-entry accounting model implementing the entity concept. All constant purchasing power of capital (a constant real value non-monetary item) being eroded / destroyed by the stable measuring unit assumption (not inflation) over time during low inflation, high inflation or hyperinflation (for example, in Zimbabwe on 20 November 2008) would mean the end of the entity. Maintaining the constant purchasing power of capital (equity) constant in real value is thus a fundamental objective for an entity.

*'It is essential to the credibility of financial reporting to recognize that the recovery of the **real** cost of investment is not earnings — that there can be no earnings unless and until the **purchasing power** of capital is maintained.'*

FAS 33 1979: 24

It is generally impossible to maintain the real value (constant purchasing power) of capital (equity) constant in **nominal monetary units** during low inflation, high inflation, hyperinflation and deflation. Financial capital **<u>maintenance</u>** in nominal monetary units is thus a fallacy during the above periods. It is, however, the capital maintenance concept most commonly used by entities as a result of historical developments in many areas over the last 3000 years.

The constant purchasing power of capital (equity) is generally automatically maintained constant with capital maintenance in units of constant purchasing power in entities that at least break even in real value - *ceteris paribus* - in terms of an index that follows all (at least DAILY) changes in the general price level.

Consequently, the IASB may determine that the objectives of general purpose financial reporting / accounting are:

1. *"To provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity."* Conceptual Framework

and

2. To legalise measurement bases that result in automatic capital maintenance in units of constant purchasing power in terms of an index that follows all (at least DAILY) changes in the general price level for an indefinite period of time in entities that at least break even in real value - *ceteris paribus* - during low inflation, high inflation, hyperinflation and deflation.

The Board may determine that the objectives of measurement thus also include:

(III) To contribute to capital maintenance in units of constant purchasing power as defined in the objectives of general purpose financial reporting / accounting above.

For example, the Board may determine that the three basic economic items are

1. Monetary items

2. Variable real value non-monetary items and

3. Constant real value non-monetary items.

The Board may determine that most IFRSs apply to the measurement of variable items under financial capital maintenance in nominal monetary units and thus require adaptation for use under capital maintenance in units of constant purchasing power in terms of an index that follow all (at least daily) changes in the general price level - where necessary.

The Board may determine that monetary items are all items in the money supply.

The Board may determine that the following are some of the items that are considered monetary items under financial capital maintenance in nominal monetary units, but are constant real value non-monetary items under financial capital maintenance in units of constant purchasing power in terms of an index that follows all (at least daily) changes in the general price level:

Trade debtors, trade creditors, all non-monetary payables, all non-monetary receivables, interest, salaries, wages, rent, fees, pensions, taxes, duties, all employee benefits and all similar items to the items already stated.

The Board may determine that constant real value non-monetary items include, but are not limited to: all items in shareholders equity, provisions, all profits and losses, all items in the profit and loss account and in the Other Comprehensive Income Statement.

The Board may determine that variable items, when they are not measured in terms of IFRS on a daily basis, are to be updated on a daily basis in terms of an index that follows all (at least daily) changes in the general price level till they are again measured in terms of IFRS.

The Board may determine that foreign exchange is a variable real value non-monetary item and that forex gains and losses are constant real value non-monetary items like all other gains and losses to be measured in units of constant purchasing power in terms of an index that follows all (at least daily) changes in the general price level.

The Board may determine that financial reports are to be updated to the current (today´s) Daily Index (e.g., the Daily CPI) after the end of the financial period. The Board may determine that it would thus be best to keep financial reports in digital form and not to print hard copies that would be out-of-date the day after the end of the financial period.

Question 26

Capital maintenance

Capital maintenance is discussed in paragraphs 9.45–9.54. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised Conceptual Framework largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change.

Do you agree? Why or why not? Please explain your reasons.

In my response to Question 11 above I stated my view that the Conceptual Framework should determine that the objectives of measurement also include:

(III) To contribute to capital maintenance in units of constant purchasing power as defined in the objectives of general purpose financial reporting / accounting above.

Accordingly, I do not support the proposal that leaves the existing descriptions and discussion of this issue largely unchanged until such time as any project on accounting for high inflation indicates a need for change. Capital maintenance is not only critical as from the onset of high inflation - although that is the generally accepted view in most - not all - accounting jurisdictions. For example, it is not viewed like that in Australia.

The IASB´s approach suggests a lack of understanding about the fundamental role a capital maintenance concept has within the accounting framework. There is clearly a pressing need to resolve the issues regarding capital maintenance now.