

EXPLORING THE RISK OF OVERSTATEMENTS AND UNDERSTATEMENTS IN FINANCIAL REPORTING DUE TO INFLATION AND DEVALUATION GAPS

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Abstract

This study explores the effects of gaps between inflation and devaluation on financial statements. A model company, which is an assumed subsidiary of a US parent, is used to report to the parent based on the current International Financial Reporting Standards (IFRS). The model company reports to its parent the different assumed inflation and devaluation rates. The ensuing results and discrepancies are discussed and explained. It is suggested that the financial statements are distorted in an economy as the current IAS 29 does not require any restatement of the financial statements until the cumulative inflation rate for the last three years is around 100%. It is also suggested that the restatement of the financial statements in local currencies to account for inflation rates prior to the conversion to the reporting currency will help solve the distortions in financial reporting for multinational companies.

Key words: *Inflation, devaluation, financial statement presentation*

Introduction

Nominal financial statements by their nature do not account for gains and losses attributable to changes in purchasing power over time. For example, while the erosion due to inflation of a firm's monetary assets such as cash is a loss to the firm, the erosion of a firm's monetary liabilities such as debt is a gain. Furthermore, even though inflation-adjusted amounts of nonmonetary items such as land accumulates inflationary effects over time to reflect changes in purchasing power, such effects are not recognized in nominal financial statements. The difference between inflation adjusted and nominal earnings represents unrecognized gains and losses from inflation (Yaniv, 2011).

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International Accounting Standards Related with Inflation and Foreign Currency Reporting

Under the current International Accounting Standards (IAS), inflation effects are not reflected on the financial statements unless the cumulative inflation in any economy for three consecutive years is nearly 100%.

In IAS 29 – *The Financial Reporting in Hyperinflationary Economies*, paragraph 3 defines the requirements of restatement of financial statements as follows:

The IAS does not establish an absolute rate at which hyperinflation is deemed to arise but allows judgement as to when the restatement of financial statements becomes necessary. The characteristics of the economic environment of a country which indicate the existence of hyperinflation include the following:

- the general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. The amounts of local currency held are immediately invested to maintain purchasing power;
- 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;
- 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;
- interest rates, wages, and prices are linked to a price index; and
- the cumulative inflation rate over three years approaches or exceeds, 100%.

Multinational companies have many subsidiaries around the world. Subsidiaries report their financial statements in two sets: one for local tax purposes and one for the parent. The local reporting is performed on the local currency of the country of operations whereas the parent reporting is performed in the currency of the country where the parent is located. For example, if the subsidiary is located in India and the parent resides in the United Kingdom (UK), then the subsidiary will report one set of the financial statements for the Indian tax authorities in Rupees and one set of the financial statements in Great Britain Pound (GBP) for the parent. The parent will then collect the same GBP denominated reports from all subsidiaries around the world to produce the consolidated financial statements for its shareholders in the UK.

Presently the subsidiaries around the world do not have to restate their financial statements in accordance with the IAS 29 unless the economy has hyperinflationary symptoms. Instead they use the IAS 21 standard – *The Effects of Changes in Foreign Exchange Rates*. IAS 21 requires subsidiaries to translate their local-functional currency transactions to the reporting currency at the prevailing exchange rate at the date of the transaction. Moreover, at the reporting period, the monetary items on the balance sheet is converted to the reporting currency from the closing parity and the differences between the historical cost transaction parity and the reporting conversion parity (either monetary gains or losses) are reflected on the income statement.

IAS 21 paragraphs 42 and 43 state the following: Special rules apply for translating the results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy into a different presentation currency.

IAS 21 paragraph 36 states the following: Where the foreign entity reports in the currency of a hyperinflationary economy, the financial statements of the foreign entity should be restated as required by the IAS 29, before translated into the reporting currency.

Since this study involves a presentation of the financial statements: one for local tax purpose and one for parent reporting-the true position of the company *vis a vis* the shareholders, there will be temporary differences between the two. This in turn will trigger the application of the IAS 12 – *Income Taxes*. Temporary differences are deemed to expire when the long term-non monetary assets and liabilities are liquidated at the end of their useful lives. Then there will not be any temporary differences between the two types of reporting and the related tax effect from the potential gains and losses should be reflected on the income statement presented to the parent. The potential income tax liability or asset arising from the temporary differences is called deferred tax asset or liability.

IAS 12 paragraph 47 states that: Deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled (liability method), based on tax rates/laws that have been enacted or substantively enacted by the end of the reporting period. Paragraph 51 states that: The measurement should reflect the entity's expectations at the balance sheet date, as to the manner in which the carrying amount of its assets and liabilities will be recovered or settled. And paragraph 53 states that: Deferred tax assets and liabilities should not be discounted.

Under normal circumstances, a devaluation of a currency against another is a product of the differences of inflation rates. For example, if the inflation figures in a year are 60% and 5% in India and the United States (US) respectively, it is expected that the Indian Currency (Rupee) will depreciate against the US Dollar (USD) $(0.6 - 0.05)$ by 55% at the end of the year. This theoretical approach is distorted in real life. The distortion occurs because of the Central Bank's intervention in the economic system. In the above example, the Central Bank of India can set the interest rate to above 60% in order to increase the real interest rate and decrease the likelihood of people being attracted to buy the USD or other stable currencies like GBP or Euro to protect their investments. These devaluations that are being depressed by the Central Banks' interventions may lead to distortion in the financial reporting.

An example of the currency devaluations depressed by monetary policies is as in Turkey.

Table 1: Inflation, Devaluation and Interest Rates of Turkey
between 1999-2008 Period

Years	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Inflation %	62.9	32.6	88.5	30.8	13.9	13.8	2.7	11.6	9.8	8.7
Devaluation %	72.1	23.4	119.9	11.8	-15	-4	0.5	4.7	-17.5	31.2
Interest %	80	70	70	64	43	38	23	27	25	19

Source: The author has prepared the above table on the basis of the information taken from Turkey's Central Bank's and Turkish Institute of Statistics' websites - www.tcmb.gov.tr and www.tuik.gov.tr respectively.

Table 1 supports the Central Bank's intervention in the economy by using monetary measures. In the years from 1999 through 2008 the interest rates have always been above the inflation rates except for in the year of its biggest economic crises in 2001. Likewise, due to the attraction of the LC interest rates, the devaluation rate has been below the inflation rate throughout the ten year period except in 1999 and 2001.

The objective of the this study is to illustrate the effects of converting the subsidiary's transactions to the reporting currency without adjusting them for the inflation effects before the conversion on the financial statements. These effects are explained with the help of tables representing the balance sheet assets, liabilities and equity items denominated on local currency, inflation adjusted-restated local currency, restated local currency converted to US-reporting currency and local currency directly converted to USD without any inflation adjustment before the conversion. Each table represents either the same or a different inflation and devaluation rate and thus shows the gaps between the two types of reporting to the parent. One is US converted directly from local currency and the other one is US converted after the local currency has been adjusted for the inflation effect.

Other Models of Current Value Reporting

Several current income and value models have been proposed to replace or operate in tandem with the historical cost (HC) convention. However, in terms of basic characteristics, they may be reduced to the following three models:

- current purchasing power (CPP) or general purchasing power (GPP);
- current entry cost or replacement cost (RC);
- current exit cost or net realisable value (NRV) (Elliot & Elliot, 2011).

The CPP model is the inflation accounting model that has been discussed in the section above. The RC model takes into account the inflation effect which is specific to the industry and calculates the replacement cost of non-monetary assets like inventory and fixed asset. The NRV model tries to measure the fair value of any asset in the market minus the costs to be encountered to sell it. For the NRV model there is no depreciation for a fixed asset. The model replaces the NRV value of every non-monetary asset (tangible and intangible fixed assets) at the reporting date. Any loss of value between

the beginning of the year and end of the year based on NRV is a loss from holding the asset for the year which replaces the depreciation. If there is no loss for the year there will be no charge to the income statement from using the non-monetary asset. In other words the NRV model measures the opportunity cost of holding the fixed assets instead of holding cash. Every method has its virtues and defects. The CPP-Inflation Accounting method can be criticized for applying a general price index where the inflation in the specific industry can be different than the general price index. In the RC method there may not be any industry specific inflation rate. Even if there is one, it might be different in different locations of the country which may still lead to a comparison problem within the same economy. It is a subjective method where the replacement costs are mostly on estimates and assessments. The NRV method is also a subjective model because there may not be a ready market for every non-monetary asset. Some fixed assets might be tailored made for the specific needs of the company and finding a ready market for the fixed assets may be quite remote. Another shortcoming of the NRV method is its violation of “going concern” principle. The method assumes the cash value of the non-monetary assets and liabilities as if the company is in liquidation at every reporting period which is not in compliance with the going concern assumption of accounting. Since both the RC and NRV models are subjective and lead to comparison problems and violation of going concern assumptions, the CPP model is been utilized in this study to reflect the inflation effects on non-monetary items. It is an objective model because a general price index is issued regularly by governments and it’s traceable because its base is always the HC before the restatement.

Literature Review

Inflation, defined as general increase in prices, is the world’s greatest robber. A covert thief, inflation steals from widows, orphans, bondholders, retirees, annuitants, beneficiaries of life insurance, and those on fixed salaries, decreasing the value of their incomes. Inflation extorts more money from the public than do all other thieves, looters, embezzlers, plunderers combined (Pearlberg, 1993).

It seems like an echo of another era. More than a quarter of a century ago, when the world experienced its first energy shock, gasoline and heating oil supplies tightened, crude oil prices rose more than threefold and industry profits skyrocketed. Today, with the Organization of Petroleum Exporting Countries once again in the driver’s seat, gasoline and heating oil supplies are tight, crude oil prices have tripled and industry profits are soaring (Oppel, 2000).

High inflation – a weakness of the Argentine economy for decades – is soaring again. Independent economists say inflation rose by 25 to 30 percent in 2010, the highest level since the calamitous 2002 devaluation that sent the economy into a tailspin. This time around, the pain is already being felt by the poor. Food-price increases began to outstrip wage increases in 2010, leading Argentines to buy less food, private economists say. And many in the middle and upper classes are leaning more heavily on credit cards, helping push up levels of personal debt. While a return to the kind of hyperinflation that swept

Argentina in the 1970s and 1980s – when retailers sometimes updated prices hourly – seems unrealistic to most, inflation shows no sign of abating and is calling into question the success of efforts for more “social inclusion” by President Cristina Fernández de Kirchner, who is expected to seek re-election in October (Barrionuevo, 2011).

Inflation in Brazil has been very high by standards compared to inflation rates experienced by industrialised even developing countries since the 1960s. It averaged 44.6% per year in the 1960s, 20.9% between 1970 and 1974, 46.5% in 1975 to 1979, 148% in 1980 to 1984, and an astonishing 707.4% in 1985 to 1989. In the first six months of 1994, it hovered on a monthly basis between 38% and 55% totalling 6,100% in the 12 months ending in June (Tullio and Ronci, 1996).

The inflation effects can translate to future cash flows because higher unrecognized inflation gains accumulated in nonmonetary assets should result in higher cash flows from operations when the assets are used-in the case of property, plant, and equipment-PPE or sold in the case of inventory-through many types of business activities, leading to a positive association between unrecognized inflation gains and future cash flows (Yaniv, 2011).

Restating financial statement means restating corporate financial statement according to the purchasing power currency at the reporting date or current replacement cost, so as to correctly reflect the real value and business performance of corporate assets, liability and equity. Specifically, by using the latest price index published by the government, the assets, liability, income, expenses, and so on are adjusted and translated in the financial statement, so that they are restated according to the current general purchasing power, which eliminate the impact of inflation. Secondly, current replacement cost is used as the basis of determination of assets valuation and profit and loss in order to detach from historical cost and value on current value rather than historical cost. It is the most radical approach to eliminating inflation, but with big difficulty and a complicated process (Zhenghong and Xianxue, 2011).

One of the major issues debated in the accounting literature over the past decade has been whether to recognize the effects of inflation (or general price-level changes) in accounting reports. Previous studies addressing this question have provided evidence on the magnitudes and on the information content of alternative inflation-accounting solutions. Those studies essentially adopted either of two approaches: (i) they compared the degree of association between abnormal security returns and (a) inflation-adjusted accounting income numbers and currently reported accounting income numbers (referring to current cost accounting), respectively; or (ii) they compared the degree of association between systematic risk of securities and the two sets of accounting numbers (Matolcsy, 1984).

The burning issue for such managers today is: “How do I set meaningful financial objectives when the value of the dollar keeps changing?” The implicit questions here are: “How do I know if I am doing a good job?” and “How do I set standards so I can measure my performance?” (Vancil, 1976).

Vancil argues that “I wish I could say that help is on the way, but my main message in this article is that the Lord helps those who help themselves. The accountants of this world worry a lot about how to measure business performance during inflation; but at this writing it is not all clear that they will agree on any of the various proposals under consideration. Worse, they may agree on a solution that fails to meet the needs of business managers. Therefore, corporate executives must become knowledgeable about the issue so that they can influence the choice. As some decisions in war are too important to be left to generals, so this decision is too important to be left to the accountants”.

Some authors (Alagiah, 2009; Aslund, 2008) even propose a world currency to solve the problem.

This paper argues that a permanent solution to the problem in accounting relating to inflation is the introduction of a single global currency. A single global currency would ensure that all countries have the same rate of inflation (if any) and all financial reports would be measured using the same monetary unit. It is the permanent solution to the issue of accounting for inflation (Alagiah, 2009).

The recent crises in the Europe Euro zone implies that this is not possible at least in the short term due to the economic discrepancies among the nations even though a single currency use has erased the currency and most of the interest rate discrepancies between the nations in the EU. However, new members are still having problems of adjustment. Latvia has a severe financial crisis, the preconditions for which have long been evident. A fixed exchange rate to the Euro led to an excessive speculative influx of capital, boosting Latvia’s private foreign debt to be 100 percent of the GDP. Inflation soared to 16 percent and the current account this year to 15 percent of GDP. Latvia’s budget has traditionally been almost in balance (Aslund, 2008).

The above sources written on inflation accounting explore the effect of inflation on the financial statements. The intent of this study is not different, however, it explores finding a solution to the effects of inflation on the financial statements and the subsidiary companies’ reporting to the parent independent of the limitations of IAS 29.

Methodology

The methodology of this paper (study) is not based on data collection. In order to measure the effects of inflation and devaluation on the financial statements (balance sheet and income statement) a model company has been developed. This company operates as a subsidiary of a parent outside the US. Its parent is located in the US and uses USD as the currency for consolidated reporting. The subsidiary has various transactions throughout the year. These transactions are handled in 4 different ways.

Firstly, they are recorded in the accounting books in the local currency (LC) at historical cost (HC) and at the end of the year the balances of ledger accounts are carried to the trial balance and then a balance sheet and an income statement are produced. This is done

first because the local legal requirements require the transactions to be recorded in legal books at LC terms. All LC figures on the first line of the tables (Tables 2 through 6) are not subjected to any IAS rules.

Secondly, the accounts in the ledger books are identified as “monetary” and “non-monetary”. Monetary assets and liabilities are the ones that are non-resistant to the effects of inflation like cash (including money in the bank account), accounts receivable, Government Services Tax (GST) or Value Added Tax (VAT) recoverable (or GST deductible as it may be called differently in some countries), accounts payable, and GST payable. Monetary assets and liabilities lose their purchasing power due to the existing inflation prevailing in an economy. An example may help explain the matter more clearly i.e. for a vendor, a 100 Dollar collected today is better than a 100 Dollar collected 6 months later and likewise for a buyer a 100 Dollar paid today is worse than the 100 Dollar paid 6 months later. This is because the vendor can gain interest on the monies collected earlier which is the same concern for the buyer that causes him/her to make a late payment in consideration of the time value of money. Non-monetary assets and liabilities are the opposite. They are inflation resistant; for example if anyone is buying a car, under normal circumstances the car’s present price will be lower than its future price. If the person defers the purchase, then s/he has to pay more Dollars to buy the same car in the future. Inventories, fixed assets (non-current assets), termination benefits, paid up capital, retained earnings and all income statement items are of non-monetary nature. Non-monetary transactions are restated. That means transaction values are carried to the year-end purchasing power by multiplying them with the inflation indexes from the date of the transaction. All income statement items including depreciation and the cost of goods sold (COGS) figures are calculated on their restated values at the year end. At year end, both the LC tax expenses and deferred tax expenses are calculated and deducted from the taxable income. Machinery and paid up capital as being non-monetary figures are restated to the year-end purchasing power. The restatements are done in accordance with the IAS 29 and are presented on the second line of the tables (Tables 2 through 6).

Thirdly, restated balance sheet figures are converted from LC to USD at closing rates at year end which are presented on the third line on the tables (Tables 2 through 6). It is required by the IAS 29 when the 3 years of cumulative inflation rate is around 100%. All figures must be presented in USD to the parent because the parent will consolidate all its subsidiaries and its own financial statements on USD basis. In the study the inflation rate is gradually increased from 0% to 30% a year. The IAS 29 is required to be applied for a 30% a year increase because the annual inflation at this level leads the three years of cumulative total inflation to exceed 100% $[(1 + 0.30)^3 = 119.6\%]$. The IAS 29 restatement rules at lower levels of inflation have been applied on the model company’s balance sheet to show the effects of inflation even with lower rates than 30% per annum.

The application of the IAS 29 is a demand from the developing countries.

Almost from the inception of the International Accounting Standards Committee (IASC) were criticized for issuing standards without regards for the needs of the developing world. The criticism was somewhat inappropriate because in practice the developing

countries were more eager to adopt the IASC's standards than the developed countries that were representing on the board. The criticism nonetheless resurfaced periodically (Camfferman and Zeff, 2000).

Fourthly, the transactions are converted to USD at the date of the transaction which is the fourth line of information in the tables (Tables 1 through 6) below. The transactions are assumed to have happened at month ends (it could have been assumed to have occurred at the beginning of the month but it would not have changed the paper's objectives). At the end of the year, after the completion of all transactions, the trial balance and the balance sheet and income statement are prepared. This is done in accordance with the IAS 21. The IAS 21 is used to convert every transaction to USD and report it at the end of the year in USD terms as the parent will consolidate in the same currency. Currently the IAS 21 Standard can (without adjusting the balances for inflation) be applied directly at lower devaluation rates until the three years cumulative inflation rate is around 100%.

The study suggests that when devaluation rates are running below the inflation rates, initially the IAS 29 rules are to be applied and then the restated figures in LC are converted to USD for foreign reporting purposes. This is deemed necessary because the non-linear relation between devaluations and inflation rates in an economy causes distortions in the financial reporting. The ultimate objective of the financial reporting to the parent is to measure the financial performance and financial position of the subsidiary in true economic values. A director at the parent's board of directors will make a decision on the terms of the reporting currency because the board is responsible to the shareholders in the US and any decision is to be explained and analysed on the US basis. Direct conversion of the LC to the reporting currency does not tell the whole story to the parent under the current IFRS reporting system. An example will make it clearer as to why do we need inflation adjustments on LC financial reports before the conversion to any reporting currency (the inflation and devaluation rates have been obtained from www.indexmundi.com website): In Angola in the years 2005 through 2008, the three years' cumulative consumer price index inflation was 48%, (yearly average 14%). While the three years' cumulative devaluation in the same period was 16% (16% appreciation of Angolan Kwanza against the US, and the yearly average appreciation rate is 6.3%). If the Angolan subsidiary of a US parent has bought an inventory at the beginning of the year for USD 1,000 equivalent of Angolan Kwanza and kept it until the year end, the year-end value of the inventory would show up as USD 1,063 (rounded, without decimals) as if its value has gone up by USD 63. In fact, its value has gone up due to first the inflation effect on the Angolan Kwanza which is 14% and the by appreciation of the currency of 6.3%. The total effect is 21.1% (1.14×1.063) which makes the US value of the inventory 1,211. The discrepancy in USD terms is USD 148 (14%). This example helps explain that the subsidiary's financial statements do not show the true financial position of the company under the current application of the IFRS. It instead shows that in case of the liquidation of the subsidiary, the parent will expect a minimum of USD 1,063 from the sale of inventory although the true value of the inflation adjusted inventory is USD 1,211.

Transactions of the Model Company

In this study, the model company goes through the following transactions in a hypothetical year of 200X:

1. Company XYZ is established with 100,000 LC capital paid as cash on January 31.
2. 100 pieces of goods are purchased on credit 100 LC each + GST (18%) on February 28.
3. Machinery purchase is made in cash for 50,000 LC + GST (18%) on March 31.
4. 100 pieces of goods are purchased on credit 120 LC each + GST (18%) on April 30.
5. 100 pieces of goods are sold to customer A on credit 220 LC each + GST (18%) on May 31.
6. Payment is made to suppliers for the first purchase (relates to transaction 2) on June 30.
7. 50 pieces of goods are sold to customer B on credit 210 LC each + GST (18%) on July 31.
8. 25 pieces of goods are sold to customer C on credit 200 LC each + GST (18%) on August 31.
9. Half of the sale's payment is received from customer A (relates to transaction 5) on September 30.
10. Payment is received from customer B (relates to transaction 7) on October 31.
11. Payment is received from customer C (relates to transaction 8) on November 30.
12. Calculation of COGS and its entry on December 31.
13. Calculation of depreciation and its entry on December 31.

GST (or VAT) in the transactions above: the GST is assumed to be 18%. Only one year of transactions are shown in the example. The local and deferred tax (due to temporary differences) rates are set the same as 25%.

The model is used under both the IAS 21 and IAS 29 assumptions with equal and different inflation and devaluation rates in the same period. This is done to show the discrepancies on the financial statements if devaluation lags behind the inflation rate or vice versa in a specific year.

The model company has one year of transactions. This one year of transactions are considered to be sufficient evidence to show the discrepancies. Here the assumption is that if the same rate of devaluations and inflations prevail in the forthcoming years the discrepancies between LC and USD denominated financial statements will even increase.

The model company does not have any export nor import activity. It is assumed to have realized its economic activities (transactions) within the borders of the country of residence. That means that the exchange rate fluctuations in import and export activities may affect the profitability of the company and may hinder the full effect of the inflation on the financial statement. For example, while there is inflation in the local economy

the currency may not devalue against the other stable currencies at the same pace; on the contrary it may appreciate against those currencies even though this may contradict with the theory.

In the following sections, numerical tables show the results of iterations on the model company at various devaluation and inflation rates in an economy during the one year period. The information contained on each line on the tables has already been explained in the earlier sections.

Table 2 shows that when the annual devaluation and inflation rates are both zero there is no effect on the balance sheet or on the income statement, assuming the parity between LC and USD is one. All the LC figures and USD figures are the same and there is no discrepancy between IAS 21 and IAS 29 figures.

The assumption in Table 3 is that both the annual devaluation and inflation rates are equal and 5% for the period. The HC-LC profit figure on the first line is higher than the LC-IAS 29 profit figure. USD-IAS 21 figures and USD-IAS 29 figures are equal (except the profit figure due to USD22 rounding error).

In Table 4, the annual inflation (10%) is twice the annual devaluation (5%). When the profit gap between the HC-LC and LC-IAS 29 figures widens, the HC-LC profit figure is higher than the LC-IAS 29 profit figure and the same difference is also observable between the USD-IAS 29 and USD IAS 21 figures. The USD-IAS 21 profit figure is higher than the USD-IAS 29 profit figure. Under the current IFRS this is the effect on the financial statements. The subsidiary reports a profit of USD 7,129 whereas its inflation adjusted profit is USD 4,087, a gap of USD3,042 or a deviation of 2.8% (3,042/108,017) on ROE on the USD-IAS 29 equity figure.

In Table 5, the annual inflation (20%) is twice as much of the annual devaluation (10%). The HC-LC figures show a profit whereas the LC-IAS 29 figures show a loss. The same situation is apparent on the USD-IAS21 and USD-IAS 29 figures. The inflation rate in Table 5 does not require any inflation adjustments-restatement of non-monetary balance sheet nor income statement items since the 3 years of cumulative inflation rate ($1.2 \times 1.2 \times 1.2 = 1.728$ which means 72.8%) is far from the 100% inflation rate required for restatement under IAS 29. Under the current IFRS the subsidiary company shows a profit of USD 3,820 whereas its inflation adjusted figures show-a loss of USD 1,913. There is a difference of USD 5,733 and a discrepancy of 5.4% (5,733/105,489) on ROE on the USD-IAS 29 equity figure.

In Table 6 the annual inflation reaches a level of 30%; its three years cumulative implication will be $[(1 + 0.30)^3 = 119.6\%]$ more than 100% which in turn will require a restatement of the LC and their conversion to USD at the closing rate as of December 31 under the current IFRS requirements. Therefore, there will be no discrepancy between the USD-IAS 21 and USD-IAS 29 figures. The subsidiary will be reporting a USD 7,108 loss to its parent.

Table 2: Annual Devaluation and Inflation are Both Zero

Annual Devaluation %	Annual Inflation %											
	0	0	0	0	0	0	0	0	0	0		
	Bank	A/R	GST/Ded.	Inventory	NCA (Net)	Total Assets	A/P	GST/Pay.	Tax Pay.	Capital	Net Inc.	Total L&Eq
Local currency-LC	60,470	12,980	12,960	3,000	45,833	135,243	14,160	6,750	3,583	100,000	10,750	135,243
LC restated-IAS 29	60,470	12,980	12,960	3,000	45,833	135,243	14,160	6,750	3,583	100,000	10,750	135,243
Restated LC converted to USD	60,470	12,980	12,960	3,000	45,833	135,243	14,160	6,750	3,583	100,000	10,750	135,243
USD values based on IAS 21	60,470	12,980	12,960	3,000	45,833	135,243	14,160	6,750	3,583	100,000	10,750	135,243

Table 3: Annual Devaluation and Inflation are Both 5%

Annual Devaluation %	Annual Inflation %											
	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
	Bank	A/R	GST/Ded.	Inventory	NCA (Net)	Total Assets	A/P	GST/Pay.	Tax Pay.	Capital	Net Inc.	Total L&Eq
Local currency-LC	60,470	12,980	12,960	3,000	45,833	135,243	14,160	6,750	3,583	100,000	10,750	135,243
LC restated-IAS 29	60,470	12,980	12,960	3,100	47,553	137,063	14,160	6,750	4,038	104,604	7,511	137,063
Restated LC converted to USD	57,573	12,358	12,339	2,951	45,274	130,495	13,482	6,427	3,844	99,592	7,150	130,495
USD values based on IAS 21	57,573	12,358	12,339	2,951	45,274	130,495	13,482	6,427	3,865	99,592	7,129	130,495

Table 4: Annual Devaluation 5% and Inflation is 10%

Annual Devaluation %	Annual Inflation %											
	5.0									10.0		
	Bank	A/R	GST/Ded.	Inventory	NCA (Net)	Total Assets	A/P	GST/Pay.	Tax Pay.	Capital	Net Inc.	Total L&Eq
Local currency-LC	60,470	12,980	12,960	3,000	45,833	135,243	14,160	6,750	3,583	100,000	10,750	135,243
LC restated-IAS 29	60,470	12,980	12,960	3,197	49,241	138,848	14,160	6,750	4,485	109,161	4,292	138,848
Restated LC converted to USD	57,573	12,358	12,339	3,044	46,882	132,196	13,482	6,427	4,270	103,930	4,087	132,196
USD values based on IAS 21	57,573	12,358	12,339	2,951	45,274	130,495	13,482	6,427	3,865	99,592	7,129	130,495

Table 5: Annual Devaluation 10% and Inflation 20%

Annual Devaluation %	Annual Inflation %											
	10.0									20.0		
	Bank	A/R	GST/Ded.	Inventory	NCA (Net)	Total Assets	A/P	GST/Pay.	Tax Pay.	Capital	Net Inc.	Total L&Eq
Local currency-LC	60,470	12,980	12,960	3,000	45,833	135,243	14,160	6,750	3,583	100,000	10,750	135,243
LC restated-IAS 29	60,470	12,980	12,960	3,387	52,545	142,342	14,160	6,750	5,358	118,178	-2,104	142,342
Restated LC converted to USD	54,956	11,796	11,778	3,079	47,753	129,362	12,869	6,134	4,870	107,402	-1,913	129,362
USD values based on IAS 21	54,956	11,796	11,778	2,906	44,751	126,187	12,869	6,134	4,158	99,206	3,820	126,187

Table 6: Annual Devaluation 20% and Inflation 30%

	Annual Devaluation %				Annual Inflation %				30.0			
	20.0	20.0	20.0	20.0	30.0	30.0	30.0	30.0				
Local currency-LC	60,470	12,980	12,960	135,243	14,160	6,750	3,583	100,000	10,750	135,243		
LC restated-IAS 29	60,470	12,980	12,960	145,781	14,160	6,750	6,218	127,182	-8,529	145,781		
Restated LC converted to USD	50,397	10,818	10,801	121,498	11,801	5,626	5,182	105,997	-7,108	121,498		
USD values based on IAS 21	50,397	10,818	10,801	118,631	11,801	5,626	4,761	98,493	-2,050	118,631		
	Bank	A/R	GST/Ded.	Inventory	NCA (Net)	Total Assets	A/P	GST/Pay.	Tax Pay.	Capital	Net Inc.	Total L&Eq

Conclusion

This study explored that even in low inflationary economic environments the financial statements should be restated. Restated financial statements presented the financial position of the company more truly. Even for LC reporting and local tax purposes the financial statements should be restated (taking into account the inflation effects on the financial statements). Restatement should be a required procedure even for local tax and stock exchange reporting requirements. Without taking into account the inflation effects there will always be over and understatements of financial statements based on the monetary situation of the company. Thus, if a company has more liquid assets than liabilities it will calculate monetary losses and otherwise it will calculate monetary gains and this will in turn affect its local tax burden. Restatement should never mean having a value for non-monetary assets exceeding their fair values. Fair value phenomenon should always be observed. If the restated value of asset (or liability) exceeded the fair value, the restated figure should be brought down to the fair value. Application of the IAS rules for foreign reporting requirements of foreign subsidiaries should be revised and subsidiaries should be first subjected to apply the IAS 29 rules and then convert the financial statements to the reporting currencies at closing rates at the date of the reporting.

Due to the lack of strong reliable economic and political infrastructure in developing countries, foreign investors ask for risk premium to bring their investments to the country. This risk premium is reflected as higher than the inflation rates. The higher inflation interest rates will keep the demands for foreign exchange low thus making the devaluation lag behind the inflation. The remedy in the short run would be to use the IAS 29 as the reporting standard at low inflation rates. As shown in Tables 2 through 6, if the multinationals apply the IAS 29 instead of the IAS 21 starting at even low inflation rates, their financial statements will show more truly the economic events that they incur throughout the financial period. In some periods the exchange rate appreciates while inflation increases or it may be the devaluation exceeding the inflation in a certain period. These are periodical economical fluctuations due to the nation's specific conditions as it is the case with Angola being an oil exporting country.

Over the long run the disparity between inflation and devaluation is expected to eliminate. It is hard to say the number of years in the long run, but it can be assumed, as the theory says, that the differences in the inflation rates should determine the percentage of devaluation. There are a number of factors as mentioned above, affecting the realization of the theory. What factors would affect the exchange rate between Kyrgyzstan and Sierra Leone if there is no trade between the two countries? However, as long as the assumption of free market economy on the world is held to be true, the theoretical approach for the currency devaluation should also be held true.

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