

## THE RELEVANCE OF ACCOUNTING INFORMATION GENERATED BY THE APPLICATION OF IAS 29 RELATED TO SHAREHOLDERS CAPITAL

Bunget Ovidiu, Dumitrescu Alin, Deliu Delia

*West University of Timișoara, Faculty of Economics and Business Administration*

**Abstract:** *The current economic environment evolves under globalization circumstances, and it stands for the markets' globalization trend. Under these circumstances, information has a primordial role. The content of the transmitted information has changed significantly. As part of the economic information, the accounting information evolved as well and its whole circuit has been continuously modernized in the rhythm of the global changes. Thus, it had to adapt to the swing of capital markets worldwide and to aim toward a unique international accounting language, for the taste and understanding of its users.*

*Historically, Romanian accounting records have been heavily influenced by the use of information for tax compliance purposes.*

*The primary function of financial/accounting details collection and recording process has been seen by many Romanian entities and management/staff within the entities (both State and private) as being for taxation compliance and taxation reporting purposes. As a result of this, the reported information has tended to reflect a "form over substance" disclosure, that is, greater importance is placed on having particular documents or recording something in a specific way, rather than in "accurately" reflecting the financial position of the enterprise at a point in time or indicating whether the results for the period are an appropriate representation of what has occurred.*

*Romanian accounting laws and regulations are not as such at fault, with the regulations providing for and encouraging treatments that are consistent in many ways with international accounting principles. Issues have however arisen on how laws and regulations are applied and have tended to reflect the background and outlook of Romanian accountants.*

*Up to 31 December 2003, Romania was considered to be a hyperinflationary economy, under the criteria of IAS 29 "Financial reporting in hyperinflationary economies". For Romanian statutory reporting, IAS 29 was not applied. In looking at financial statements where there are significant non-monetary items, users should keep this in mind and consider if there have been any revaluation of tangible and intangible assets and on what basis.*

*The objective of IAS 29 is to establish specific standards for entities reporting in the currency of a hyperinflationary economy, so that the financial information provided is meaningful. Our empirical analysis encompasses a hyperinflationary economy covering a wide variety of hyperinflationary conditions.*

**Keywords:** *hyperinflation, IAS 29, monetary items, accounting information*

*JEL Classification: M40, M41*

## **I. Introduction**

Starting with the financial year that ended at 31<sup>st</sup> of December 2012, the economical entities quoted on the Bucharest Stock Exchange were obliged to present their annual financial statements in accordance with the International Financial Reporting Standards (IFRS), in the way they were approved by the European Union, the legal requirement being stipulated by the Ordinance no. 881/2012 issued by the Finance Ministry and by the Ordinance no. 1286/2012 issued by the Finance Ministry for approving the Accounting Regulations in accordance with the International Accounting Standards, applicable for the companies holding stock exchange quotations.

Romanian entities are not on their first experience concerning the application of IFRS. Another precedent already exists – applying the Ordinance no. 94/2012 issued by the Finance Ministry for approving the Accounting Regulations harmonized with the 4<sup>th</sup> Directive of the European Economic Communities and with the International Accounting Standards, between 2001 and 2005, when the Romanian National Referential has been substituted for the one prescribed by OMFP no. 94/2012, by taking into consideration carrying out two out of three criteria regarding the turnover, total assets and number of employees.

The applying marked the beginning of a new stage in the life of the Romanian professional accountants through the new born challenges, although it was done in a „traditional” way, just like in the sketches of the Romanian writer Caragiale – „ok to get it revised, but without changing anything”. The adhering to the European Union meant also a step „aside” for the Romanian accounting, by giving up on the OMFP no. 94/2001 and applying accounting regulations in accordance with the European Directives; still, it is true that the substantial deviation that was already existing at the beginning of 2000 has disappeared.

The partial applying of the International Accounting Standards has had as a consequence the not applying of IAS 29, although, till the end of the financial year 2003, the Romanian accounting was characterized by hyperinflation. On 31<sup>st</sup> December 2012, this datum has changed – IFRS are being integrally applied, but the economic reality is different – almost 10 years had passed since Romania got out of the hyperinflation area.

## **II. Literature review / previous research**

Our study case’s premise starts from the economic reality of applying the IFRS starting with 31<sup>st</sup> of December 2012 and from the already existing materials in the specialty literature.

Since this debate is a new one – applying IFRS (and, in consequence, IAS 29) in Romania by the entities quoted on the capital market at 31<sup>st</sup> December 2012, we have not found any Romanian specialty literature that would have approached this subject until now. Also, the International specialty literature that approached this matter is extremely reduced.

Still, we can emphasize Higson's point of view<sup>12</sup> concerning IAS 29. Empirical evidence is presented on the efficacy of procedures summarised in IAS 29: Financial Reporting in Hyperinflationary Economies for estimating the loss in purchasing power from holding monetary items during hyperinflationary periods. His empirical analysis encompasses 32 hyperinflationary economies covering a wide variety of hyperinflationary conditions and spanning a period of more than 80 years. While the estimation procedures summarised in IAS 29 perform poorly under all the hyperinflationary conditions encompassed by our sample, they are especially poor when the rate of inflation accelerates towards the end of a relatively short hyperinflationary period. For these latter economies, the best estimate of the actual purchasing power loss is typically only a small fraction of the figure obtained under the IAS 29 procedures. For hyperinflations of longer duration, the IAS 29 procedures return estimated purchasing power losses that are typically around 10% larger than our best estimate of the actual losses. Higson also derives and empirically tests a general class of 'two point' estimation formulae that make more efficient use of the sparse information set on which the IAS 29 estimation procedures are based.

The results obtained from this procedure are encouraging and suggest it is possible to obtain reliable estimates of purchasing power losses using only sparse information sets provided realistic assumptions are made about the way monetary holdings respond to variations in the purchasing power of the currency.

### III. Research methodology

According to IAS 29 and IAS, the financial statements of an entity that reports in the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the balance sheet date; therefore, the non-monetary items should be restated by applying a general price index at the acquired or contribution date. The Standard states the fact that an economy is being considered hyperinflationary when, among other factors, the cumulative inflation rate over three years approaches, or exceeds, 100%.

In order to observe the application of IAS 29 stipulations by the Romanian entities that are quoted on the Bucharest Stock Exchange, we have selected a sample of five companies: Biofarm SA, Boromir Prod SA, Compa SA, Electroputere SA and Farmaceutica Remedia SA. The reason we chose these five is because they are the first five companies that published their preliminary financial statements at 31st December 2012 on the Bucharest Stock Exchange website, [www.bvb.ro](http://www.bvb.ro).

### IV. Research results

The continuous decrease of inflation and other factors connected to the characteristics of the Romanian economical environment, indicates that the economy, which had its functional currency adopted by the entities quoted on the Bucharest Stock Exchange, ceased to be under hyperinflation starting with 1<sup>st</sup>

---

<sup>12</sup> Higson, A., Shinozawa, Y., & Tippett, M. (2007). *IAS 29 and the cost of holding money under hyperinflationary conditions*. *Accounting and Business Research*, 37(2), 97-99, 101-107, 111, 113-114, 119-121. Retrieved from <http://search.proquest.com/docview/198109635?accountid=8107>

January 2004. This way, the amounts stated in the monetary unit at 31<sup>st</sup> December 2003 are treated as a basis for the valuation in the financial statements.

In the context of applying professional judgment, only three categories remain in the scope of inflating valuations: property, plant and equipment, share capital and reserves at 31<sup>st</sup> December 2003. Given that subsequent laws (from 31<sup>st</sup> December 2003 onwards) prescribed the revaluation of property, plant and equipment at fair market value, the application of revaluation by inflating becomes redundant.

*What happened to the value of the share capital?* It was more than often increased with revaluation surpluses before 31<sup>st</sup> December 2002, for the purpose of keeping a fair view on the financing sources. These revaluations under the prescriptions of IAS 29, must be written off from the value of the share capital, reclassifying them as retained earnings. The problem is that under Law no. 82 / 1991, accounting documents must be kept for ten years, thus giving rise to a high risk of being unable to perform the restatements, in the absence of proper documentation.

The accounting treatment for *inflating the share capital* is:

<b>118</b>	<b>=</b>	<b>1028</b>
<b>Retained earnings from the first time adoption of IAS 29</b>		<b>Adjustments to share capital</b>

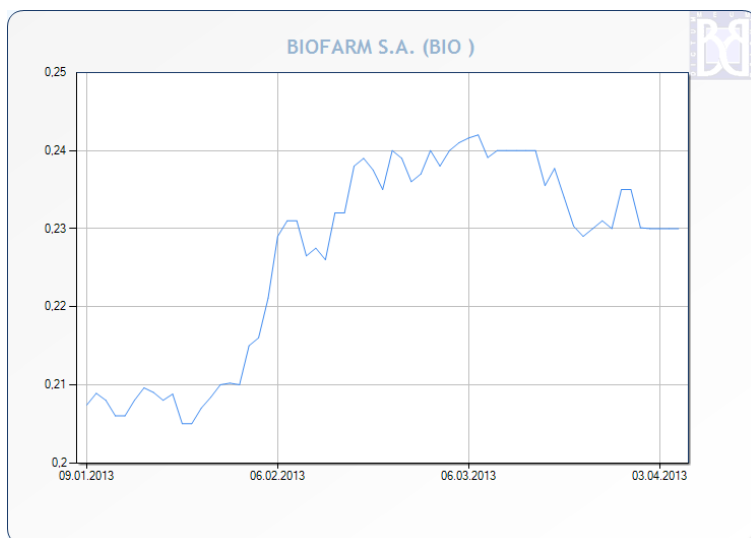
The effect is that the share capital is increased with the inflation differences, which in turn express nominal value loss of the currency. These differences are subsequently covered by the same extra capital resulting from the inflation. This way, the operation is reversed and at this point we question the motivation of performing the restatement in the first place.

There is a distinct possibility that a shareholder requests to withdraw from the capital structure of the entity, between the moment of submitting the financial statements, which contain the inflated capital, and the actual moment of covering the retained loss from the restatement. In this situation, *which is the valuation used to assess the shareholder's equity?* Based on the adjustment made on the presumption of hyperinflation, the valuation should be the inflated amount (which, as a parenthesis, can exceed the total value of share capital in existence before the inflation). An early conclusion can be drawn from here that the inflation of share capital can lead to the presentation of redundant information and to the representation of the capital structure in a manner far from being true and fair.

From our sample of five entities, we have found that three of them did not perform a share capital inflation: Farmaceutica Remedia SA, Compa SA and Electroputere SA. The remaining two, Biofarm SA and Boromir Prod SA presented, in their preliminary financial statements as at 31<sup>st</sup> December 2012, adjustments to share capital resulting from inflation, as follows:

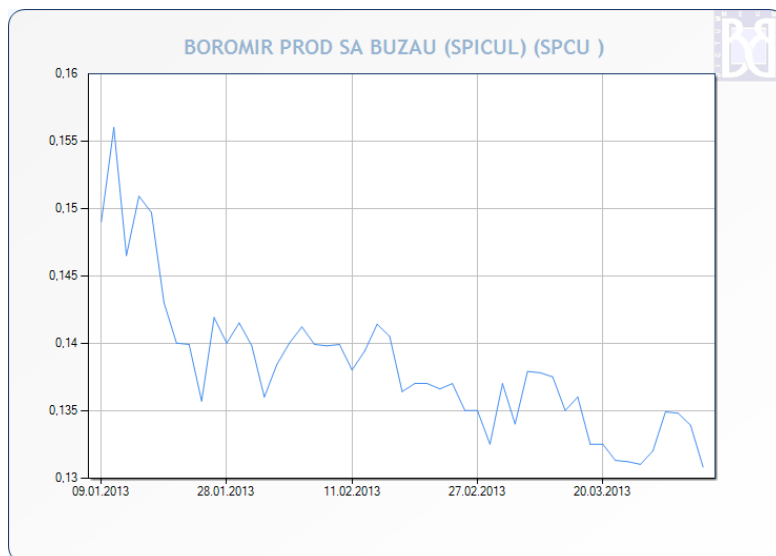
- i) Biofarm SA had a share capital of RON 109,486,150 as at 31<sup>st</sup> December 2012, and adjustments amounting to RON 24,983,008 representing adjustments to share capital based on the rate of inflation.
- ii) Boromir Prod SA had a share capital of RON 23,306,374 as at 31<sup>st</sup> December 2012, and adjustments amounting to RON 34,396,893 representing adjustments to share capital based on the rate of inflation.

In order to be able to draw a conclusion regarding the relevance of inflating the share capital as per IAS 29, we have followed the fluctuation of the exchange rate from the date of the preliminary financial statements at 31<sup>st</sup> December 2012, until 15<sup>th</sup> February 2013, as per the graphics below:



**Graphic no. 1** – Fluctuation of the exchange rate from the date of the preliminary financial statements

Source: <http://www.bvb.ro/ListedCompanies/EmitGrafic.aspx?s=BIO>



**Graphic no. 2** – Fluctuation of the exchange rate from the date of the preliminary financial statements

Source: <http://www.bvb.ro/ListedCompanies/EmitGrafic.aspx?s=SPCU>

It can be observed that a significant value resulting from the restatement of the share capital did not impact in large fluctuations in respect of the stock exchange rate.

## V. Conclusions

The conclusion of this paper is that the very relevance of the accounting information is questioned in the matter of inflating share capital as per IAS 29, along with the utility of such information.

There are also important costs with updating the share capital value with the National Office of the Commerce Registry and with the re-actualization, which is in fact supported by the going concern principle, meaning that the shareholders have provided financing sources which can be considered as being stated in real and not nominal currency terms.

The very same reporting framework indicates, in IAS 1, paragraph 23:

*In the extremely rare circumstance that the leadership concludes that comply with a requirement set out in a standard or interpretation, leading to confusion as to conflict with the objective of financial statements established in the Conceptual Framework, but the regulatory framework will ban fail to implement this requirement, the entity must reduce as far as practicable those aspects of performance that perceived as causing confusion by revealing the following information:*

- a. *The title of the Standard Interpretation or concerned, the nature of the invitation, as well as why management has concluded that compliance with the same confuse so that would conflict with the objective of the financial statements set out in the Framework;*
- b. *for each year presented, adjustments to each item of financial statements that management has concluded that it would take to achieve the true picture.*

In conclusion, some entities' management did not choose to consider the effects of hyperinflation on the share capital, because this aspect is, in their opinion, an accounting adjustment which does not reflect the legal nature of the capital holdings and which can give rise to confusion among the shareholders, as to the differences in share capital which would result in comparison to the statutory financial statements.

## VI. References

1. \*\*\* *International Financial Reporting Standards*, CECCAR Edition, 2011
2. \*\*\* *Accounting Law no. 82/1991*, with the latest updates
3. \*\*\* *Ordinance no. 881/2012 issued by the Finance Ministry*
4. \*\*\* *Ordinance no. 1286/2012 issued by the Finance Ministry* for approving the Accounting Regulations in accordance with the International Accounting Standards, applicable for the companies holding stock exchange quotations.
5. \*\*\* [www.bvb.ro](http://www.bvb.ro)