Topic No. D-55

Topic: Determining a Highly Inflationary Economy under FASB Statement No. 52

Date Discussed: November 14, 1996

An FASB representative announced that the FASB staff has been asked to interpret the guidance in FASB Statement No. 52, *Foreign Currency Translation,* for purposes of determining if an economy should be considered highly inflationary. Specifically, the staff has been asked how the determination of the cumulative inflation rate and the exercise of judgment should affect the final assessment of whether an economy is highly inflationary.

Paragraph 11 of Statement 52 defines a highly inflationary economy as one that has cumulative inflation of approximately 100 percent or more over a 3-year period. Paragraphs 104 and 109 of Statement 52 provide insight into the Board's rationale for this definition and state:

> The point at which a substitute measuring unit is necessary is a subjective one. It depends on a number of factors, including the current and cumulative rates of inflation and the capital intensiveness of the operation. In principle, however, a more stable measuring unit is always preferable to a less stable one. [paragraph 104]
>
> The definition of a highly inflationary economy as one that has cumulative inflation of *approximately* 100 percent or more over a 3-year period is necessarily an arbitrary decision. In some instances, the trend of inflation might be as important as the absolute rate. It is the Board's intention that the definition of a highly inflationary economy be applied with judgment. [paragraph 109]

The FASB staff believes the determination of a highly inflationary economy must begin by calculating the cumulative inflation rate for the three years that precede the beginning of the reporting period, including interim reporting periods. If that calculation results in a cumulative inflation rate in excess of 100 percent, the economy should be considered highly inflationary in all instances. However, if that calculation results in the cumulative rate being less than 100 percent, the staff believes that historical inflation rate trends (increasing or decreasing) and other pertinent economic factors should be considered to determine whether such information suggests that classification of the economy as highly inflationary is appropriate. The staff believes that projections of future inflation rates were not contemplated by the language in paragraph 109 and thus projections cannot be used to overcome the presumption that an economy is highly inflationary if the 3-year cumulative rate exceeds 100 percent.

The following examples are provided to illustrate the application of the guidance described above:

Example A:

Country A's economy at the beginning of 19X9 continues to be classified as highly inflationary because the cumulative 3-year rate is in excess of 100 percent. The recent trend of declining inflation rates should not be extrapolated to project future rates in order to overcome the classification that results from the calculation.

Fiscal year	**X1**	**X2**	**X3**	**X4**	**X5**	**X6**	**X7**	**X8**
Annual inflation rate	9%	8%	12%	17%	33%	52%	30%	15%
Cumulative 3-year rate[1]			32%	42%	74%	137%	163%	127%

Example B:

Country B's economy at the beginning of 19X9 should continue to be classified as highly inflationary even though the cumulative 3-year rate is less than 100 percent because there is no evidence to suggest that the drop below the 100 percent cumulative rate is other than temporary and the annual rate of inflation during the preceding 8 years has been high.

Fiscal year	**X1**	**X2**	**X3**	**X4**	**X5**	**X6**	**X7**	**X8**
Annual inflation rate	15%	28%	46%	41%	35%	29%	23%	21%
Cumulative 3-year rate[1]			115%	164%	178%	146%	114%	92%

Example C:

Country C's economy at the beginning of 19X9 should no longer be classified as highly inflationary because the cumulative 3-year rate is less than 100 percent and the historical

[1] Amounts are calculated as a compounded 3-year inflation rate.

inflation rates suggest that the prior classification resulted from an isolated spike in the annual inflation rate.

Fiscal year	**X1**	**X2**	**X3**	**X4**	**X5**	**X6**	**X7**	**X8**
Annual inflation rate	5%	6%	4%	7%	12%	55%	18%	6%
Cumulative 3-year rate[1]			16%	18%	25%	86%	105%	94%

The SEC Observer noted that the SEC staff will expect all registrants to begin applying the guidance in this FASB staff announcement for reporting periods beginning after December 31, 1996. The SEC Observer also noted that this guidance would apply to investments in Mexico.

[1]Amounts are calculated as a compounded 3-year inflation rate.